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The Nuts and Bolts of Replacement Property Identification

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The identification of replacement property is one of the basic requirements of a Section 1031 Like-kind Exchange. While this may sound like a simple concept, it is a critical component of an exchange transaction since an identification that does not meet the requirements of Section 1031 can ruin an entire exchange. This article will address some common identification questions and misconceptions.

How long does the taxpayer have to identify?

The taxpayer has 45 days from the date of the relinquished property closing to identify replacement property. The days are calculated as calendar days and include weekends and holidays. The deadline expires at 11:59pm on day 45, with no extensions for holidays or weekends. Extensions are only available if the taxpayer, the relinquished property, or the replacement property is affected by a Presidentially declared disaster, as set forth in an IRS notice of extension, or if the taxpayer is serving in active military duty, in a combat zone.

How many properties may be identified?

The taxpayer may identify as many properties as he wishes, but he must follow two rules regarding the number of properties identified:

1. The 3-property rule: The taxpayer may identify **up to 3 properties** without regard to the fair market value of the properties.

2. The 200% rule: If the taxpayer identifies **more than 3 properties**, the total combined fair market value of all the properties identified cannot be more than 200% of the fair market value of the property or properties relinquished. For example, if a taxpayer sells one property for $100,000.00 and identifies more than 3 replacement properties, the aggregate value of all 3 properties cannot exceed $200,000.00.

It is important to note that these rules apply to the number of properties **identified,** not the number of properties purchased. The taxpayer must also be aware that a property that is acquired prior to the expiration of the 45-day identification period is deemed identified, whether or not it was identified in writing by the taxpayer. The taxpayer must remember to include such a property when calculating the number of properties identified.

A violation of the 200% rule will result in a void identification. A void identification may be saved, however, if the taxpayer acquires 95% of the total fair market value of all the properties identified. In essence, this requires that the taxpayer purchase everything he identified. It is generally considered dangerous for the taxpayer to rely on this rule when identifying, since failure to receive all the property may make the entire exchange fail. If a taxpayer inadvertently violated the 200% rule, however, acquisition of all the identified properties may save his exchange.

What type of form is necessary for identification?

Although no specific identification form is required, every identification must be in writing, signed by the taxpayer and must be hand delivered, mailed, faxed, or otherwise sent by the deadline date. A mailed identification is considered sent as of the postmark date. A taxpayer who faxes his identification should keep his fax confirmation report as proof of the transmittal, in the event that the qualified intermediary does not receive the fax. The identification may also be sent via email, as long as an electronic signature is included.

To whom must the identification be made?

The identification must be made to a party to the exchange. If the qualified intermediary safe harbor is being utilized, the qualified intermediary is the appropriate party to receive the identification. In certain instances, it may be possible for the taxpayer to make the identification to the seller of the replacement property, in which case, it is advisable that the replacement property purchase contract include language specifying that the property is replacement property in the purchaser's 1031 exchange transaction.

The identification cannot be made to a disqualified party. A disqualified party is an agent of the taxpayer at the time of the exchange, and includes related parties, as well as anyone who has acted as the taxpayer's attorney, accountant, realtor, investment

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banker, or employee within the past two years. Taxpayers often mistakenly believe that they have made a proper identification by sending their identification form to their attorney.

Once a taxpayer identifies, may he make any changes to the identification?

The taxpayer may change his identification at any time prior to the expiration of the 45-day deadline. He may identify one property initially and then identify another property at a later date during the 45-day period. He may also revoke an identification prior to the 45-day deadline, but the revocation should be in writing and signed by the taxpayer. Once the 45-day deadline expires, however, the taxpayer may not make any changes to his identification, including adding or deleting properties.

What happens if a taxpayer, through no fault of his own, is unable to purchase a property that he has identified?

The Tax Code states that any property received by the taxpayer shall be treated as property which IS NOT like-kind property if the property was not identified within the 45-day ID period. Unfortunately, the IRS does not have the authority to provide for a good-faith exception to the 45-day identification rule. If the taxpayer is unable to purchase his replacement property, for whatever reason, he may not substitute another property if the 45-day deadline has expired. This is one of the most common questions that we receive from taxpayers. The Tax Code and the IRS regulations are very firm and clear that the only replacement property qualifying in the transaction is that property which was timely identified.

How specific must the property description be?

The property must be described adequately enough so that it cannot be mistaken for another property. An adequate description would include a street address, lot number in a platted subdivision, tax parcel identification number, legal description or an identifiable name, such as a shopping center or apartment complex. Any identification should also include the city or county and state in which the property is located.

If the taxpayer is buying less than a 100% interest in the property, he should identify the specific interest that he is purchasing; e.g., a 50% undivided interest. If the taxpayer has not yet determined the percentage interest he will purchase, he may instead identify the value of the replacement property; e.g., a $400,000 undivided interest.

The taxpayer must purchase “substantially the same” property as that identified. One example in the IRS Regulations allows for a 25% variance between what was identified and what is actually purchased.

What if the taxpayer is building improvements on the property?

Any improvements that are to be constructed on the property prior to the taxpayer’s acquisition of the property must be specifically identified. The taxpayer can attach a description of the improvements, a drawing or building plan, or the specifications list that was attached to the purchase contract. The taxpayer should provide as much detail as possible about the improvements to be constructed.

Must the taxpayer be under contract before identifying property?

No, there is no requirement that the taxpayer be under contract when he identifies his replacement property, but being under contract at the time of identification will increase the likelihood that the taxpayer will actually be able to acquire the identified property.

Must the taxpayer buy everything he identifies?

No, the taxpayer is not required to purchase everything identified. The taxpayer may identify multiple properties as his replacement property. Because of the nuances of the identification requirements, it is a good idea for the taxpayer to review his identification with his tax advisor, and send his identification to the qualified intermediary as soon as possible, prior to the expiration of the 45-day deadline. This allows the qualified intermediary the opportunity to review the identification and contact the taxpayer if there are obvious red flags. We, at Investors Title, are happy to review identifications ahead of time and point out any suggested changes or clarifications, but it is the taxpayer’s responsibility to seek advice from his tax advisor to ensure he has made a proper identification. By carefully considering these identification rules, as well as other 1031 exchange requirements, a taxpayer can successfully defer recognition of capital gains, upon the exchange of investment or business properties.

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