

What are the Rules for Identification and Receipt of Replacement Property in an IRC §1031 Tax Deferred Exchange?

Why is it Necessary to Identify Replacement Property?

In a typical Internal Revenue Code (IRC) §1031 delayed exchange, commonly known as a 1031 Exchange or tax-deferred exchange, an Exchanger 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 Exchanger has 180 days (shorter in some circumstances) to acquire one or more of the identified properties, which is known as the exchange period. Property(ies) actually acquired within the 45-day identification period do not have to be specifically identified, however they do count toward the 3-Property and 200% Rules discussed below.

These rules are a direct result of the Starker case where for the first time an Exchanger was found to be able to sell Relinquished Property on one day and acquire Replacement Property at a different point in time. In fact, the Starker case involved a five-year gap between the sale and purchase. Prior to the decision in the Starker case, it was believed that an exchange had to be simultaneous. As a result of the open-endedness of this decision, as part of the Tax Reform Act of 1984, Congress added the 45/180 day limitation to the delayed exchange. 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 are the Identification and Receipt Rules?

The identification rules in a 1031 Exchange include the following:

- The 45-day requirement to designate Replacement Property
- The 3-Property Rule
- The 200% Rule
- The 95% Rule
- The Incidental Property Rule
- Description of Replacement Property
- Property to be produced

The 45-day Identification Rule

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, however a written statement in a contract to purchase the Replacement Property stating that the Buyer is identifying the subject property as his replacement would meet the requirements of the identification.

The restriction against providing the notice to a disqualified person is that such a person may be likely to bend the rules a bit based upon the person's close relation to the Exchanger. Disqualified persons generally are those who have an agency relationship with the Exchanger. They include the Exchanger'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 new identifications, but only if done so within that the identification period.

The 3-Property Rule

This rule simply states that the Replacement Property identification can be made for up to "three properties without regard to the fair market values of the properties." At one time in the history of §1031 Exchanges, there was a requirement to prioritize identified properties. At those times, if an Exchanger wished to acquire a second identified property, they could not do so unless the first identified property fell through due to circumstances beyond the Exchanger's control. Presumably this harsh requirement played a role in the 1991 Treasury Regulations where the 3-Property Rule is found. By far and away, most Exchangers utilize this rule.

The 200% Rule

The 200% Rule states the Exchanger may identify:

"Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer."

Another way to state this is that the Exchanger can identify any number of properties and actually close on any number of them if the sum of the market value of all of them does not exceed twice the market value of the Relinquished Property. There is some uncertainty of how the market value of these properties is determined. The listing price? The amount the seller is willing to accept? The amount that the Exchanger agrees to pay? The answer is unclear, but using the listing price would surely be a safe choice.

The 95% Rule

The 95% Rule is defined as follows:

"Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties."

As a practical matter, this rule is very hard to adhere to. Basically, it provides that should the Exchanger have over identified for purpose of the first two rules, the identification can still be considered valid if the Exchanger receives at least 95% in value of what was identified. For example, if an Exchanger identified four properties or more whose market value exceeds 200% of the value of the Relinquished Property, to the extent that the Exchanger received 95% of what was “over” identified, then the identification is deemed proper. In the real world, it is difficult to imagine this rule being relied upon by an Exchanger.

The Incidental Property Rule in Section 1031

The incidental property rule is defined as follows:

“Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if - (A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and (B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.”

In other words, if there is some incidental property that typically passes to a Buyer in standard commercial transactions for this kind of property sale, to the extent that the value of any such property is less than 15% of the primary property, the incidental property does not have to be separately identified.

To illustrate this rule, the exchange regulations use the example of an apartment building to be acquired for \$1,000,000 which includes furniture, laundry machines and other miscellaneous items of personal property whose aggregate value does not exceed \$150,000. In this example, those various items of personal property are not required to be separately identified nor does that property count against the 3-Property Rule. Be aware however that this rule only applies to identification and not to making sure that Replacement Property must still be like-kind to the Relinquished Property. For example, if the Relinquished Property was real estate with a value of \$1,000,000 and the Replacement Property was real estate with a value of \$850,000 plus incidental property of \$150,000, the Exchanger will still have tax to pay (known as “boot”) because the incidental personal property was not like-kind to the Relinquished 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 the written document or agreement.
- Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building).
- Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make and model.
- 1031 Exchange Property to Be Improved or Produced

Oftentimes, the property intended to be acquired by the Exchanger will be in a different physical state at the time it is identified than it will be upon receipt by the Exchanger. The regulations account for this by requiring the identification for real estate to include the address or legal description of the property plus as much detail as practical about the intended improvements. In connection with the receipt of property to be improved, even if the described improvements are not completed at the time it is received by the Exchanger, the exchange is valid so long as the actual property received does not differ from what was identified by the Exchanger except for the degree of improvements that have been completed. Personal property is a bit different in this regard and the “production” (improvements) needs to be completed within the 180-day term.

Summary

The ability to defer associated taxes through a §1031 Exchange is a very valuable benefit to Exchangers. 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 in order to comply with the technical requirements of this IRC section. In fact, the property identification rules are so germane to a proper exchange, that there is a question asked of the Exchanger on the exchange reporting form 8824 about compliance with these rules.