



MADISON 1031

Beat the Buzzer:

Replacement Property Identification

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Time constraints are part and parcel of every 1031 Exchange. While the properties do not need to be exchanged simultaneously, the 45 day identification deadline and the 180-day Exchange period can be daunting to the unprepared taxpayer. Sure, the benefits of doing a 1031 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 their potential Replacement Property within 45 calendar days. This includes weekends and holidays, so even if the 45th day is on a legal holiday, such as Independence Day or Memorial Day, the property still must be identified by midnight. The IRS does not care about your holiday barbeque or beach outing! In even the best buyer's market, a month and half is just not much time to find a suitable investment property, and the process may not be as easy as it seems.

Written Identification

The Treasury Regulations are very particular about how Replacement Property must be identified. Property received by the taxpayer before the 45th day is deemed satisfactorily identified. That is easy enough.

Replacement Property that will be acquired after the 45th day must be identified **in a written document signed by the taxpayer and delivered to either the Qualified Intermediary facilitating the 1031 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 insurance company involved in the purchase might also be acceptable parties to receive the identification.

A **“disqualified person”** would include an agent of the taxpayer, such as any person who as 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.

Describing the Replacement Property

The written identification must unambiguously describe the Replacement Property. 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 acquire “substantially the same property” they 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. So, if

a taxpayer identified 201 Park Avenue, New York, NY as a Replacement Property, but only acquired a 2% Tenant In Common interest in that property, the IRS could disallow the 1031 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 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."

Identifying Multiple Properties

Once the 45th day identification period has expired, the taxpayer may only acquire a Replacement Property that has been properly identified. They 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 their 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;

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; 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.

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”), but since violating the 200 Percent Rule could result in the entire 1031 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.

Planning

Given the time constraints, advanced planning is essential for a smooth 1031 Exchange. As discussed in our article *Avoiding Real Estate Heartbreak: Laying the Foundation for a Successful §1031 Exchange*, Investors should start shopping for their Replacement Property well before their Relinquished Property closes. Doing so allows the Investor time to negotiate the Contract of Sale and conduct due diligence before deciding on which properties to include. Additionally, many Investors will consider listing alternative properties, such as Delaware Statutory Trust interests, which are typically readily available and close fairly quickly, or a Reverse Exchange, where they would close on their Replacement Property *before* closing on their Relinquished Property. (See *Bending Over Backward: Reverse 1031 Exchanges*)

About Madison 1031

Madison 1031 is a Qualified Intermediary, handling all types of §1031 Exchanges nationwide for over two decades. Madison 1031's team of Exchange professionals -- including attorneys, accountants and Certified Exchange Specialists® -- represents a deep bench of experience that has facilitated thousands of forward, delayed and construction §1031 Exchange transactions. We educate our clients on the requirements for a successful §1031 Exchange and help them identify key issues that could impact their transaction. While Madison 1031 can handle even a last minute §1031 Exchange, the earlier we are involved the better able we are to assist. We coordinate the Closing with the Investor's attorney or title insurance company, depending on local custom, and guide the parties through the acquisition of the Replacement Property. Madison 1031 is committed to providing exceptional customer service every step of the way.

About Michael Brady, Esq. CES®

Michael S. Brady, Esq., CES® is Executive Vice President for Madison 1031 Exchange, a national Qualified Intermediary for tax-deferred Exchanges pursuant to Internal Revenue Code §1031. As a Certified Exchange Specialist® and an attorney, his responsibilities include consulting with clients and their advisors on the regulations affecting §1031 Exchanges, as well as giving seminars for attorneys, accountants, and real estate professionals, and publishing articles on tax and legal issues. Prior to joining Madison 1031, Mr. Brady was Vice President of Eastern Operations for Asset Preservation, Inc., the §1031 Exchange qualified intermediary subsidiary of

Stewart Title Insurance Company, where he managed sales and operations staff handling several thousand transactions annually. During his career, he has headed up two other §1031 Exchange companies, and has acted as general counsel for a title insurance company. As an attorney, Mr. Brady has over 20 years' experience representing clients in commercial and residential real estate transactions, as well as a wide variety of business transactions and commercial litigation matters. Mr. Brady received a Bachelor of Arts degree from Binghamton University, and earned his Juris Doctorate from New York Law School, where he was a member of the Law Review and graduated Cum Laude.