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The importance of proper identification, rules & regulations in a 1031 exchange - by Lynne Bagby

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In today's fast-paced and frothy real estate market throughout New England and across the country, locating the desired replacement investment property, getting offers accepted and coming to agreement are all collectively challenging. When adding the use of Section 1031 for tax deferral in the mix, taxpayers who are actively involved in a 1031 exchange on their investment real estate sales should have a good understanding of the replacement property identification rules, requirements and procedures required to have a valid and successful 1031 exchange transaction.

The identification period in a 1031 delayed exchange begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th calendar day thereafter. To qualify for a 1031 exchange, the tax code requires identifying replacement property: in a written document signed by the taxpayer; hand-delivered, mailed, telecopied or otherwise sent; before the end of the identification period (within 45 calendar days); to either the person obligated to transfer the replacement property to the taxpayer (generally the qualified intermediary) or any other person involved in the exchange other than the taxpayer or a disqualified person. Some examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, a closing attorney, and an escrow agent at a title company. The replacement property must be unambiguously described (i.e. legal description, street address or distinguishable name). Improper identification in a 1031 exchange can cause a 1031 exchange to fail.

Issues to consider when identifying replacement property in an exchange include situations when taxpayers plan to acquire real property which is being constructed must identify the real property and the improvements in as much detail as is practical at the time the identification is made. Taxpayers who intend to acquire less than 100% ownership interest in the replacement property should state the specific percentage of interest. This is an important aspect whenever identifying replacement property as part of a "fractionalized ownership" investment, like a TIC (Tenant-in-Common) or a DST (Delaware Statutory Trust). Taxpayers should always consult with their tax and/or legal advisors about the explicit rules and restrictions for identifying replacement property in a 1031 exchange.

Any properties acquired by the taxpayer within the 45-day identification period are considered properly identified. A taxpayer has the ability to substitute new replacement property or properties by revoking a previous identification in the same manner as originally identified and to subsequently identify new replacement property or properties as long as this is done in writing, within the 45-day identification period. Although taxpayers can identify more than one replacement property, they must adhere to one of the three identification rules as follows:

“3 Property Rule”: three replacement properties without regard to their fair market value; “200% Rule”: any number of replacement properties so long as their aggregate fair market value of all replacement property does not exceed 200% of the aggregate fair market value of all relinquished properties; or, the “95% Rule”: any number of replacement properties without regard to the combined fair market value, as long as the replacement properties acquired amount to at least ninety-five percent of the fair market value of all identified properties.

To better understand the importance of the Section 1031 identification rules it is important to note that the 45-day identification period is set in stone; there are no extensions. The only exception would be for a federally declared disaster and then only if the IRS notice specifically cites extensions to the 1031 exchange timelines which would include the 45-day identification period for the distinct federally declared disaster areas stated in the notice. Although, for the first time in history, in 2020 the IRS issued Notice 2020-23 which granted 1031 exchange timeline extensions nationwide for the COVID-19 pandemic.

Additionally, on IRS form 8824 (“Like Kind Exchange” form), Part 1, Item #5 the IRS asks for the following information: “Date like-kind property you received was identified by written notice to another party (see instructions for 45-day written notice requirement); (month, day and year).” As both IRC Section 1031 and IRS Form 8824 indicate, there is no leeway whatsoever in properly identifying replacement property in a 1031 exchange. The requirements for the proper method of identifying replacement property are clear and any attempt to try to circumvent these rules is considered tax fraud and could result in significant negative consequences for the taxpayer.

In the Tax Court case, *Dobrich vs. Commissioner* (October 20, 1997), the taxpayers committed tax fraud by falsifying the date property was identified. The taxpayer misrepresented to the IRS that they had properly identified replacement property by back-dating documents in an attempt to reflect that an oral identification had been made. They tried to fabricate their identification and created false documents to attempt to substantiate their claim. The Court found evidence of the Dobrich’s intent to defraud and ruled that they were liable for a Section 6663 fraud penalty. In addition, the taxpayers plead guilty to a criminal charge of causing the delivery of false documents to the IRS. Ultimately, the taxpayers were liable for the \$2.2 million in capital gain taxes they were attempting to defer, plus an additional 75% fraud penalty for an additional \$1.6 million.

The bottom line is this: every taxpayer participating in a 1031 exchange, should make sure that they properly identify replacement property within the 45-calendar day identification timeline pursuant to the Section 1031 rules and Treasury Regulation guidelines.

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