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Identifying replacement properties in a 1031 tax-deferred exchange by Brendan Greene and Mark McCue

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Internal Revenue Code (IRC) Section 1031 allows a property owner, who holds property for “the productive use in a trade or business or for investment” to defer paying capital gains taxes if the property owner sells such property, identifies “like kind” property within forty-five days of the sale, and acquires “like kind” property within one hundred eighty days of the sale.

The real estate market has continued to be a seller’s market. Years 2021 and 2022 saw historically low interest rates, which in turn caused historic demand in investment properties and 1031 tax-deferred exchanges despite the high price of such properties for sale. With increased mortgage rates, current investors who have mortgages on their property will be more hesitant to sell if they have to purchase another investment property with a much higher interest rate.

With the current low inventory of investment properties on the market, it is important for investors to be well-versed on the rules for identifying replacement properties, in order to keep all of their options open for a better chance at successfully completing a 1031 exchange. Once a taxpayer sells their relinquished property, they have 45 days to identify replacement property. The identification of the property should be as specific as possible. There should be a street address listed if available, otherwise an unambiguous legal description. Be sure to include any unit numbers if the replacement property is a condominium, or any tenant-in-common interest percentages if the taxpayer is only buying a portion of the replacement property. Generally, a taxpayer may identify up to three properties, regardless of their price. As such, if an investor sells a rental office condominium, or any

other real estate held for investment, for \$1 million, the investor can identify three investment properties of any type of real estate with values of \$800,000, \$1.5 million and \$5 million or any combination of fair market values.

However, a taxpayer also has the option of identifying more than three properties, provided they follow one of two additional rules:

1. The 200% Rule.

The 200% Rule states that you can identify more than three properties so long as the fair market value of all the properties you identify is not more than twice as much as the value of the relinquished property. So, for example, if you sell your two-family rental property for \$550,000, you would be able to identify four or five different investment condominium units for \$200,000 each because the fair market value of the four or five units would be less than \$1.1 million, which is less than 200% of the value of your relinquished property.

2. The 95% Rule

The 95% Rule states that you can identify as many properties as you like, so long as you close on 95% of the value of those identified properties – which essentially means you need to close on all of them. Practically speaking, this is difficult to accomplish. However, the 95% Rule is available to a taxpayer, so it is important to note here.

Another way to handle the strict rules of identifying replacement property within 45 days is to structure a “Reverse Exchange” or a “Construction Exchange.”

We still expect to continue to see a sustained demand of “Reverse Exchanges” and “Construction/Improvement Exchanges.” A Reverse Exchange is when an investor buys the replacement property first, and then sells their relinquished property second. Because of the somewhat limited supply of investment properties available, investors are not willing to sell their property and be left without anything to purchase. Reverse Exchanges can be a useful tool to ensure a successful purchase of replacement property before relinquishing their current investment property. A Construction/Improvement Exchange is when an investor either constructs a building on vacant land as part of the replacement property or makes improvements to an existing building within the one hundred eighty-day exchange period. This allows investors much greater flexibility to accomplish an exchange by having the ability to look at a broader spectrum of price ranges for replacement properties, and if properly structured, will have a successful result in deferring capital gains taxes.

Our exchange company, Greater Boston Exchange Company, LLC (a subsidiary of McCue, Lee & Greene, LLP) is owned and operated by attorneys Brendan Greene and Mark McCue with combined experiences of over 50 years in real estate law and tax issues. We act as both qualified intermediaries for exchanges and as consultants to investors, borrowers, attorneys and accountants to facilitate successful exchanges.

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