

Identification of tenant in common replacement properties and partial interests for 1031 exchanges

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Most investors structuring their transaction as a 1031 exchange are aware that they must identify their replacement property within 45 days of the sale of their first relinquished property. For example, the identification of the replacement property will read "123 Main St., Anytown, USA", or some suitable derivative specifically identifying the property, such as a tax block and lot. If the taxpayer is acquiring a 100% interest in the property an identification merely listing a property address would be entirely correct.

But what about if the taxpayer is only acquiring a 10% interest in that property? Is that identification still correct? For purposes of the 200% rule would an exchange be valid if the value of the property were stated on the identification as \$800,000, but only a \$200,000 interest in the property were acquired?

In order to satisfy the requirements of Treas. Reg. 1.1031(k)-1(d)(1) a taxpayer must (i) receive the replacement property before the end of the exchange period; and (ii) the replacement property received is substantially the same property as identified. (emphasis added). While the IRS has not assigned a percentage value, or some other means to define what is "substantially similar", there is a strong likelihood that the two examples previously given would not yield a valid exchange. In addition, the Treasury Regulations provide that if the taxpayer has identified more than one replacement property the requirement to receive "substantially the same property as identified" is applied to each property.

With the proliferation of tenant in common replacement properties, more commonly known as a "TIC" property, more and more taxpayers are choosing a partial interest in a replacement property. It is important to remember that a taxpayer who ultimately purchases a fractional interest in a replacement property must identify it as such. If the taxpayer merely uses an address without limiting the percentage interest to be acquired, or as in the case of the 200% rule, does not limit the dollar value of the replacement property, there is a very good chance the exchange would not be valid.

Many times when taxpayers are making their identification they are uncertain what percentage interest they would like to acquire in a replacement property. Taxpayers often are unsure of their closing costs for both the relinquished and replacement properties, and thus are not in a position to make a specific identification. Fortunately, the Treasury Regulations provide that the replacement property acquired must merely be "substantially the same" as what was identified, not 100% the same.

If a taxpayer identifies an 8% interest in a TIC property and ultimately purchases an 8.5% interest in the replacement property is that substantially the same? Most likely the Internal Revenue Service would view this as a valid exchange. If that same taxpayer identified a TIC property but failed to

include a percentage interest to be acquired on the replacement property identification form, an acquisition of only 8.5% would most likely not be considered substantially similar.

Lastly, many taxpayers tend to think in terms of their cash exchange funds, but forget about replacing their debt when acquiring replacement property. If a taxpayer had a relinquished property which was only 20% leveraged, using that same cash to buy a 70% leveraged property will lead to a much higher value. These facts must be taken into consideration when determining the amount of replacement property to be acquired.

In closing, it important to pay close attention to either the percentage interest or value of the replacement property to be acquired when making an identification. Failure to acquire substantially similar property may yield an invalid exchange. Always make sure to check with your tax and/or legal advisor when making your identification.

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