

# Exchange News

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Realty Exchange Corporation

**Your nationwide Qualified Intermediary for tax deferred exchange of real estate.**

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## Critical Importance of 45 Day Identification.

As reported in a recent Wall Street Journal article the IRS is concerned with the validity of 45 day identifications. IRC 1031(a) (3) (A) states that "any property received by the taxpayer shall be treated as property which is not like-kind property if – (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange."

The IRS regulation on deferred like-kind exchanges [Section 1.1031(k)-1(c)] provides additional guidance on the 45 day identification requirement. If the taxpayer transfers more than one relinquished property, then the identification period starts on the date the first relinquished property is transferred. Any replacement property that is received by the taxpayer before the end of the 45 day identification period will be considered identified.

Replacement property is properly identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period. Our exchange agreement requires it be sent to us as the Qualified Intermediary.

Replacement property is identified only if it is "unambiguously described" in the written document. Generally, this means it is described by a legal description or street address. To identify a potential or alternate replacement property, the property does not have to be under contract. At any time during the 45 day identification period a previous identification may be revoked and a new signed and dated identification list submitted.

If the exchangor will be purchasing a partial interest in a replacement property that percentage should be so stated in the identification letter. Example: 50% interest in 123 Baker St., Any Town, NC.

Special identification requirements exist for the identification of property to be built.

This means that after the identification is made and before receipt of the property, it will be in whole or part constructed, built, installed, manufactured, developed or improved. The identification must include the legal description and "as much detail regarding construction of the improvements as is practicable". To qualify as like kind the property eventually received must be "substantially" the same property as identified.

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The taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred in the same exchange the maximum number of replacement properties that the taxpayer may identified is:

a. three properties of any fair market value (the 3 property rule)

or

b. any number of properties as long as their aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all the relinquished properties transferred (the 200% rule).

If at the end of the identification period the taxpayer has identified more properties than permitted under the 3 property or 200% rules above, the taxpayer is treated as if no replacement property has been identified -- except for a property received during the identification period; or if before the end of the 180 day exchange period, the taxpayer receives identified property totaling 95% of the fair market value of all the properties identified (the 95% rule).

Shortly after settlement of the relinquished property we provide an exchangor with a 45 Day Identification form letter, the 45 and 180 day suspense dates, and a letter explaining the identification rules. The 45 day identification is a critical part of a Like Kind exchange. It must be completed in strict compliance with the IRS regulation.

Owner Held Notes.

We are frequently asked if an owner can hold an Installment Note from the buyer of the relinquished property and still do a Like Kind exchange. The simple answer is yes. However, the principal amount of the Note will be taxed as capital gain as it is received. If the Note is of a high value, the taxpayer needs to evaluate how much additional capital gain will be deferred by also doing a tax deferred exchange.

If the taxpayer is going to take back a Note two different approaches may be taken:

First – at settlement the Exchangor receives the Note directly from the buyer and the value of the Note becomes taxable income as non-like property and may be treated as an installment sale, OR

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Second – at settlement the Qualified Intermediary receives the Note directly from the buyer. The Note is made payable to the Qualified Intermediary. The Note becomes part of the qualified escrow held by the Qualified Intermediary and can be disposed of in a number of ways. For example, the Note can be sold to a third party or used as part of the compensation for the purchase of the replacement property. If the Note matures or is paid off before transfer of the replacement property the funds are added to the exchangor's qualified escrow account.

A popular choice is for the exchangor to purchase the Note from the Qualified Intermediary at the settlement of the last replacement property, with the funds going toward the purchase of that replacement property. This permits the gain to be deferred as part of the exchange. If all else fails, then after the exchange the Note is endorsed by the Qualified Intermediary to the Exchangor and the Note may be reported as an installment sale. While holding the Note the Qualified Intermediary must collect interest and comply with all the other provisions set forth in the Note.

## Realty Exchange Corporation

"Your Nationwide Qualified Intermediary since 1990"

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