

Basic Identification Questions

A taxpayer may identify new properties utilizing one of two rules. There is also an exception to the two rules. But for ease of discussion, let's say there are three identification rules. They are mutually exclusive, **so a taxpayer may only use one rule at a time.**

Let's say a taxpayer sells an investment property for \$100 dollars:

3 PROPERTY RULE

Identify one, two or three properties of any value and purchase one, two or all three properties. Providing the fair market value of the new property or properties is equal or greater to the sales price of the relinquished property, the taxpayer receives 100% deferral of their taxes.

If however, a taxpayer identifies more than three properties, then they move to the 200% Rule.

200% RULE

This applies if a taxpayer identifies more than three potential replacement properties.

So, if a taxpayer identifies four or more potential new properties, unlike the 3 Property Rule, the taxpayer must add up the total fair market values of all of the properties on their list. The sum must not exceed 200% of the sales price of the relinquished property. In our example, since the taxpayer sold for \$100, the total for all of the properties on the list must not exceed \$200.

Additional Examples:

- (A) If a taxpayer identifies 5 properties and each property costs \$30, then they have identified \$150 of fair market value, which is less than the \$200 they were able to identify. **THIS IS A VALID IDENTIFICATION**
- (B) If a taxpayer identifies 10 properties and each property costs \$30, then they have identified \$300 of fair market value, which is greater than the \$200 they were able to identify. **THIS IS AN INVALID IDENTIFICATION**

If a taxpayer's list contains more than three properties and is not in conformance with the 200% Rule, the taxpayer will not be eligible for tax deferral under Section 1031 of the Tax Code unless they are able to satisfy the 95% Exception:

95% EXCEPTION

This only applies when a taxpayer identifies more than three properties and the list is not in conformance with the 200% rule. The exception is that if a taxpayer closes on 95% of the properties on their list, regardless of the number of properties, they have a valid identification:

- In example (B) under the 200% Rule above, the taxpayer identified \$300 of property which exceeded the \$200 they could have validly identified. So to qualify for the 95% exception, they must close on 95% or greater of the \$300 the taxpayer identified.
- This means that the taxpayer must close on \$285 out of the 10 properties identified. Each property cost \$30, so to satisfy the 95% requirement, the taxpayer would need to close on all 10 properties to end up with a valid exchange.
- If the taxpayer only purchases 9 of the \$30 properties, then they would have purchased \$270 out of the \$300 identified and thus NOT purchased 95% or greater of the fair market value that was identified. **THESE TRANSACTIONS WILL INVALIDATE THE 1031 EXCHANGE.**

Please contact us for further information or to discuss your specific 1031 situation.