

Improvement Exchanges for Commercial and Residential Property

In the current real estate market there are many opportunities to acquire distressed property at a fraction of the price. Investors can take advantage of this market by selling their relinquished property in a 1031 tax deferred “improvement” exchange and purchasing replacement property that might need construction work or improvements.

The improvement exchange, also known as a build-to-suit or construction exchange, allows an investor to use the proceeds from the sale of the relinquished property not only to acquire replacement property, but also to make improvements to the property. For example:

If an investor sells relinquished property with a fair market value of \$1 million, debt of \$200,000 and equity of \$800,000, he must acquire a property equal to at least \$1 million and must invest at least \$800,000 into that property in order to completely defer his tax in a 1031 exchange. In an improvement exchange, however, the investor could acquire property worth only \$300,000, borrow an additional \$200,000 and spend the remaining \$500,000 of exchange proceeds plus the \$200,000 in loan funds on improvements to the property. This would use up the remaining cash and increase the fair market value of the replacement property to \$1 million, resulting in a fully tax deferred exchange.

Structuring an Improvement Exchange

An improvement exchange is accomplished by having a separate entity called an “exchange accommodation titleholder” or “EAT” temporarily take title to the replacement property while the improvements are being made. The EAT is necessary because any work done to the property after the investor takes title to it is not considered like kind property and therefore will not increase the value of the property for exchange purposes. First American Exchange creates and owns this entity which holds title to the property for up to 180 days. During that time frame the investor controls the construction, not First American Exchange. The costs of construction are paid for either by the investor, a loan, or by using the funds from the sale of the relinquished property.

Benefits and Drawbacks of Doing an Improvement Exchange

The benefits of doing an improvement exchange include the ability to buy property that is lower in value compared to the relinquished property while still having a completely tax-deferred exchange, and to use exchange funds rather than loan proceeds to fund construction.

The principal drawback of doing an improvement exchange is that the work must be done within the 180 day period in order to have any effect on the exchange. In addition, improvement exchanges can be more costly due to fees and costs of an additional closing and formation of the EAT.

Planning for an Improvement Exchange

For those intending to do an improvement exchange, planning ahead is essential.

- First, include a provision in the purchase contract that it is assignable in connection with a 1031 exchange. This is necessary because the EAT, rather than the investor, will be taking title to the replacement property.
- Contact First American Exchange and your lender early in the process. Typically the EAT signs the loan documents and the loan must be completely non-recourse to the EAT.
- Get an accurate estimate of the amount of time it will take to complete the construction project. Although the construction does not have to be complete at the expiration of the 180 day period, the only improvements that will affect the value of the replacement property for exchange purposes are the improvements that are done as of the date that the EAT transfers the replacement property to the exchanger.
- Finally, always consult with your tax advisor before doing any exchange, including an improvement exchange.

By properly structuring an improvement exchange, the investor should have much more flexibility in finding appropriate properties and at the same time completely defer all capital gains tax. To discuss your particular circumstances and for additional information, contact us at First American Exchange Company.

SUZANNE KENNEDY

COMMERCIAL 1031 EXCHANGE CONSULTANT

MOBILE 949.296.5402

sukennedy@firstam.com

www.firstexchange.com



**First American
Exchange Company™**

877.317.1031 ▼ www.firstexchange.com