



## IMPROVEMENTS ON REPLACEMENT PROPERTIES

An exchangor may want to rehabilitate or construct improvements on a Replacement Property to increase its value to match or exceed the exchange value of the Relinquished Property.

This presents problems given the time constraints associated with a delayed forward tax deferred exchange. Any improvements paid for with exchange funds must be completed within 180 days of the closing of the Relinquished Property and before the transfer of the Replacement Property to the exchangor.

The acquisition of the Replacement Property by the exchangor may be viewed as a "snapshot," which freezes the funds in the exchange account. Funds left in the exchange account after the snapshot closing date may no longer qualify for tax deferral even if the funds are spent to improve the Replacement Property after the conveyance of the property by the Qualified Intermediary to the exchangor.

### THE SELLER MAY CONSTRUCT IMPROVEMENTS ON THE REPLACEMENT PROPERTY BEFORE CLOSING

The best practice is to convince the Replacement Property Seller to construct the improvements within the 180 days period with their own funds and increase

the sales price of the Replacement Property to accommodate those expenditures. If the Seller is reluctant to use their own money, the Qualified Intermediary may advance to the Seller the required funds through secured loans out of the exchange funds held by the Qualified Intermediary.

## THE QUALIFIED INTERMEDIARY MAY CONSTRUCT IMPROVEMENTS

If the Seller is unwilling to construct improvements to the Replacement Property, the Qualified Intermediary may purchase the Replacement Property and then construct the required improvements with exchange funds prior to transferring the Replacement Property to the exchangor. We refer to this as an Improvement Exchange.

An Improvement Exchange is a delayed forward exchange in which the Qualified Intermediary retains ownership of the Replacement Property and makes improvements to it. The improved property is conveyed upon the *first* of 3 time periods:

- All of the improvements have been accomplished;
- All the exchange funds have been used or the Exchange Value as been met;
- The 180<sup>th</sup> day has been reached.

Once the improvements have been made to the Replacement Property, ownership is passed to the exchangor by deed from the Qualified Intermediary and the exchange is completed. An Improvement Exchange provides exchangors with flexibility to either improve an existing structure or actually construct a new structure on raw property acquired by the Qualified Intermediary.

An Improvement Exchange is a procedure to balance an exchange and avoid tax liability for the exchangor client. For example, if the exchangor disposes of property at one specified value and acquires a Replacement Property at a lesser value, there could be capital gains tax liability on the difference. The exchangor may reduce or eliminate this tax liability by increasing the value of the Replacement Property through improvements made during the exchange period.

Under most circumstances, Improvement Exchanges may only be accomplished if there is adequate cash to pay for the Replacement Property and improvements, or the seller is willing to carry the financing. If conventional or bank financing is required to purchase the land or pay for the improvements, most lenders will not lend directly to the exchangor if a Qualified Intermediary holds title to the property pledged as collateral for the loan. It is possible for the Qualified Intermediary to sign a subordination agreement, or even execute the loan documents, but potential liability typically deters the Qualified Intermediary from doing so.

The following is an example of an Improvement Exchange in which the Replacement Property is acquired and the improvements are paid with 100% cash: The exchangor transfers a real piece of property to the Qualified Intermediary valued at \$250,000.00 with no debt. The Qualified Intermediary sells the property and uses \$50,000.00 of the cash from the Relinquished Property sale to purchase a piece of unimproved land. Once the land has been acquired by the Qualified Intermediary, the Qualified Intermediary (through the exchangor) makes arrangements with a contractor for improvements in the amount of \$200,000.00. The Qualified Intermediary will remain in title to the property and pay the contractor until the funds are expended. Once the improvements have been made, the Qualified Intermediary will transfer the property to the exchangor at a value of \$50,000.00 plus the improvements of \$200,000.00 for a total exchange value of \$250,000.00.

The standard forward delayed exchange time requirements still apply to an Improvement Exchange. The exchangor must identify the real property to be acquired as well as the specific improvements to be made to the property within 45 days of the closing on the Relinquished Property. These improvements must be described in the Declaration with as much detail as possible. The needed improvements must be actually installed and the property transferred to the exchangor within 180 days of the closing of the Relinquished Property. All the improvements to the Replacement Property do not have to be completed within 180 days. Only enough work needs to be actually completed to increase the value of the Replacement Property to a level equal to the exchange value of the Relinquished Property. The Regulations do specifically state the finished project must be substantially the same as the property and improvements identified in the Declaration. In other words, an exchangor cannot identify a 50-unit apartment complex to be constructed and end up with a three story office complex constructed instead.

Careful consideration of timing should be at a forefront when planning an Improvement Exchange. While the improvements themselves can often be completed within the 180 days, external factors may influence the pace of the installation of those improvements. Issues such as weather conditions; ease of obtaining building permits, and delays in construction should be calculated and necessary steps should be taken to minimize any potential problems.

Many exchangors wrongly believe they can make the needed improvements after escrow closes and they have received title to the Replacement Property. This alternative is not valid for improvements because once the escrow closes, any cash not used for improvements to the Replacement Property is "Boot" to the exchangor. If the exchangor has constructive receipt of the funds, he will have a tax liability on the amount received.

The Improvement Exchange affords the exchangor great opportunities to acquire desirable Replacement Properties. If the obstacles of financing, identification and timing can be overcome, an exchangor may end up with an ideal property suited to his specific needs.

Careful structuring of this arrangement is essential. Any construction contracts should be between the Qualified Intermediary and the contractors. Bills for the improvements should be made out in the name of and paid for by the Qualified Intermediary, or the LLC it uses to acquire and hold the property during the course of the Improvement Exchange. Changes to the Tax Code preclude a related party taking title to the Replacement Property and constructing the improvements and then deeding to the exchangor.

Sometimes, none of the alternatives presented above are feasible or acceptable to the exchangor. Often, improvements cannot be completed within 180 days because of building permit lead time or the extent of the improvements required.

## REFINANCING THE RELINQUISHED PROPERTY PRIOR TO THE EXCHANGE

Refinancing the Relinquished Property prior to the sale of the Relinquished Property would place more of the equity of the Relinquished Property in the hands of the exchangor outside of the exchange. These refinancing proceeds could then be used to construct the improvements on the Replacement Property after closing of the Replacement Property. Because the funds would come from the exchangor, rather than from the exchange funds, the exchangor should get tax basis for the value of the improvements to the Replacement Property.

This refinancing approach would require that the Replacement Property value (before improvements) be high enough to match the Relinquished Property value. The refinancing of the Relinquished Property should be completed as early as possible before the sale of the Relinquished Property. The refinancing of the Relinquished Property will raise the amount of debt needed on the Replacement Property and will lower the amount of cash in the exchange account.

Problem: The Exchangor may have to establish an independent business purpose for the refinancing of the Relinquished Property so close in time to the tax deferred exchange so that the IRS cannot argue that the borrowing was done to either:

- A. Reduce the amount of cash to be reinvested in the Replacement Property;

OR

- B. The refinancing was done just to circumvent the time deadlines for completion of the improvements.

THIS LITERATURE IS PRODUCED TO PROVIDE A GENERAL OVERVIEW OF THE TAX-DEFERRED EXCHANGE PROCESS. YOU SHOULD NOT DEPEND UPON THIS LITERATURE WHEN DETERMINING WHETHER OR NOT YOU MAY WANT TO COMPLETE A TAX-DEFERRED EXCHANGE. YOUR DECISION TO DO SO RESTS ENTIRELY WITH YOU, WITH THE ADVISE OF YOUR OWN ACCOUNTING AND LEGAL PROFESSIONAL, WHETHER THAT BE YOUR ACCOUNTANT, C.P.A. OR ATTORNEY. WE ARE QUALIFIED INTERMEDIARY'S AND ARE BY I.R.S. REGULATION PRECLUDED FROM ACTING AS YOUR QUALIFIED INTERMEDIARY IF WE HAVE BEEN YOUR ATTORNEY OR ACCOUNTANT DURING THE TWO(2) YEAR PERIOD BEFORE YOUR EXCHANGE. AS YOU CAN SEE, OUR SERVICES AS FACILITATOR DO NOT REPLACE THE TRULY PROFESSIONAL SERVICES OF YOUR ATTORNEY OR ACCOUNTANT!