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**Valuable Information for Real Estate Professionals and their Clients**

# Improvement or Build-to-Suit Exchanges

## WHAT IS AN IMPROVEMENT EXCHANGE?

An improvement exchange, also referred to as a construction or build-to-suit exchange, gives an Exchanger the opportunity to make improvements on a replacement property using exchange equity. In some situations, an Exchanger wishes to sell a qualifying property and utilize their tax-deferred dollars to build or improve new investment property. It is important for the Exchanger to consult a tax or legal advisor to ensure that the proposed improvements qualify for tax deferred treatment.

## IMPROVEMENT EXCHANGE REQUIREMENTS

As with any §1031 exchange, the Exchanger is governed by a 45 day identification period. In an improvement exchange the Exchanger must not only identify potential replacement properties within the 45 day period, but they must also identify the improvements to the properties that will be complete by the 180 day completion period. If it is determined that the construction process will exceed the exchange timeframe, then only those improvements that will be complete by the end of the exchange should be identified.

Another requirement to be aware of is that exchange funds can only be utilized for capital improvements. The Exchanger cannot acquire personal property, such as a trailer, to assist them in the construction of the improvements. However, renting a trailer to aide in the construction of improvements would be acceptable. Finally, only completed improvements that are permanently affixed to the property can be paid for with exchange funds.

## PROCESS OF THE IMPROVEMENT EXCHANGE

An Exchanger sells a relinquished property for $500,000 and the funds are held with a Qualified Intermediary (QI). The Exchanger has 45 days to identify potential replacement property, along with improvements. All desired replacement property and improvements must be acquired within 180 days from the closing on the relinquished property.

On day 30, a replacement property is purchased for $200,000. The QI uses exchange funds to close the purchase and instructs that the deed pass directly from the seller to an Exchange Accommodation Titleholder (EAT). As improvements are completed, the Exchanger approves the draw requests and submits them to the QI for payment. Pursuant to the exchange agreement, when all exchange funds are used, and all requirements are met, then the exchange is complete. At this time the EAT will transfer the property to the Exchanger.

## POTENTIAL STUMBLING BLOCKS

Based on current legal authority, an Exchanger may not do an improvement exchange on land they already own. Creative practitioners have made attempts to avoid this blockade by utilizing a long-term leasehold interest. However, these transactions do not fall under the “safe harbor” of the IRS.

A second obstacle can arise when a lender is involved on an improvement exchange. This is due to the EAT holding title to the replacement property during the improvement process. However, this is overcome in most cases resulting in a successful exchange!