1031 Exchange FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS

> Construction/Improvement Exchange

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.

In a typical 1031 exchange, relinquished property is sold and the exchange funds generated from the sale are used to acquire replacement property. On occasion, an investor may want to use available funds to construct improvements to the replacement property. Such a process is aptly named "Construction/Improvement Exchange" and is an accepted method of exchanging under current tax law (Revenue Procedure 2000-37)

A construction/improvement exchange presents three notable challenges.

1. The investor cannot own the replacement property at the time exchange funds are used to construct improvements. Therefore, an Exchange accommodating Titleholder (EAT) will take title to the replacement property during the improvement phase. The qualified intermediary working on the exchange will generally set up the EAT.

2. The second challenge is financing the replacement property. Lenders generally do not want to make a loan to the EAT. Even if the investor is qualified and approved for a loan, the lender will want the title holder to be the borrower. As title holder, the EAT is not usually an acceptable borrower. Almost always, a construction/improvement exchange requires the investor to purchase the replacement property all cash. Given this challenge, a construction/improvement exchange is generally best suited for investors who do not have a loan on their relinquished property and whose exchange is therefore an all cash exchange.

3. Finally, a construction/improvement exchange will add several thousand dollars in additional exchange fees and closing costs to the exchange transaction which makes it the most expensive method of exchanging.

Advanced Issues:

- The investor will be in charge of all improvements and will have full access to the replacement property during the EAT ownership.
- Only improvements completed prior to the end of the 180 days exchange period will count towards the replacement property value, so major improvement projects will be or impossible to complete
- In order for the EAT to take title and then transfer ownership to the investor, a single member LLC will usually be used. At the completion of the exchange, the Eat will generally transfer the LLC to the investor rather than recording a deed. Transferring the LLC to complete the exchange will likely save on transfer taxes but will require the investor to manage the LLC after the completion of the exchange.
- Construction/improvement exchange also requires specific and unique tax reporting at year end and the Qualified Intermediary will assist with such reporting.

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