

Construction (Improvement) Exchanges

The 1031 Regulations do not allow for the prepayment of improvements to be made to a replacement property after the title is transferred to the exchanger. Funds held in escrow by the title company for repairs do not qualify. This is based on the premise that prepayment is not “like-kind” to real property. However, a construction exchange can be accomplished that will allow the use of exchange proceeds to acquire and improve the replacement property.

Requirements: The completion of the exchange is allotted the same 180 days as all other exchanges. This means that all improvements that are to be included in the exchange must be **completed prior** to the exchanger’s receipt of the property. Again, prepaid labor, a load of bricks, or a stack of lumber does not qualify for payment with exchange funds. While the construction or improvements to be made to the replacement property must be identified in the ID letter by the 45th day, the taxpayer will receive credit for any construction completed prior to the transfer even if the whole project was not completed by the 180th day.

The **election to do construction** on the replacement property **MUST** be done **prior to closing** on the replacement property even before the 45th day. The replacement property is deeded to the holding entity (a LLC) at closing instead of the exchanger.

Method: Simply, the exchanging taxpayer enters into an Exchange Agreement with the Texas 1031 Exchange Company to acquire the replacement property using a holding entity, improve the property to the exchanger’s specifications, and then convey the improved property to the exchanger at the end.

The actual mechanics of the transaction are a little more complicated. The replacement property is acquired and deeded to a single member limited liability company (LLC). This is a disregarded entity by the IRS for tax purposes but is subject to Texas franchise law. The intermediary takes assignment to the construction contracts and the exchanger and intermediary cooperate in the construction of the improvements. The exchanger is still responsible for all construction steps as the named Project Manager, but the intermediary and exchanger jointly approve disbursements of the exchange proceeds and other construction funds.

The funding of the construction is done with exchange proceeds from the relinquished property via a loan from the exchanger’s escrow (QI to the LLC), funds loaned to the intermediary by the exchanger, and third party lenders. The funds loaned to the intermediary are made on a non-recourse basis and guaranteed by the exchanger.

When construction is completed or the exchange period is about to expire, the replacement property is “sold” to the exchanger by transferring the membership interest in the LLC to the

exchanger. The LLC is still holding title to the property along with the title insurance.

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