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CONSTRUCTION IMPROVEMENT 1031 EXCHANGE OPPORTUNITIES *BY: MARY LOU SCHWAB CPA, CES*



1031 Exchangers often acquire replacement property which requires improvements or renovations. By utilizing an "Improvement or Construction Exchange" it would be possible for an exchanger to receive property that is renovated, improved to the exchanger's specifications in a 1031 tax deferred exchange. An improvement or construction exchange can allow an exchanger to acquire and improve property and defer capital gains tax.

With an "Improvement or Construction Exchange" proceeds from the sale of relinquished property are received and held by Bankers Escrow Corporation as provided by IRS rules in Revenue Procedure 2000-37. The transfer of the completed replacement property is made within 180 days after the relinquished property sale. Funds from the relinquished property are used to supplement other financing which permits both the purchase and construction of improvements on the replacement property. It is necessary that all improvements and funds be utilized within the 180 day period after the sale of the relinquished property or the parking of the replacement property.

The steps in an improvement exchange are:

1. Exchanger sells old property and enters into an exchange agreement. The Exchanger has 45 days from the closing date of the old property to identify replacement property.
2. Replacement property in need of improvements is required to be placed under contract specifying that the "Buyer and/or Assigns" will be purchasing the property. Before closing, Bankers Escrow sets up an Exchange Accommodating Titleholder entity to purchase the property to be improved. This Exchange Accommodating Titleholder is a newly formed Limited Liability Company (LLC). The Exchangers 1031 proceeds are utilized by the LLC to acquire the property to be improved. If there are not sufficient exchange funds for the purchase, the LLC will obtain additional funds from the Exchanger or together with the Exchange obtains a commercial bank loan.

3. The Construction Improvement Exchange Agreement is prepared and entered into by the Exchanger. The replacement property is acquired by the LLC. The Exchange may enter into a General Contract Agreement with the LLC for the improvements to be constructed. The improvements must be substantially complete within the 180 days from the date that the Exchanger's old property is sold or the replacement property is parked in the LLC. All construction draws are approved by the Exchanger and the LLC makes arrangements with Bankers Escrow Corp. for the payment from the 12031 proceeds held, or coordinates the construction draw requests with the bank.

4. Once the improvements are complete the new improved option price of the property is determined (original acquisition cost plus improvements). The property is scheduled to close on or before the 180th day deadline. The improved property is sold from the LLC to the Exchanger as their replacement 1031 property. The exchange is complete!

The improvement or construction exchange allows the LLC to utilize funds generated from the relinquished property to improve the new property. Unlike a simple 1031 exchange, however, the replacement property is "parked" by the LLC during the allotted 180 day construction window. This involves a greater understanding and expertise by a qualified intermediary.

The IRS rules specify that improvements on property an exchange has already acquired will not count as replacement property in a 1031 tax exchange. Consequently, setting up a construction exchange prior to any replacement property purchase is mandatory. At Bankers Escrow Corporation, we are well versed in the tax requirements for construction improvement exchanges and facilitate them in a very professional manner.

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