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Getting credit for property improvements in a Section 1031 exchange

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Frequently, New England investors ask whether they can buy an investment property and make improvements to it as replacement property in a Section 1031 exchange. The answer is "yes" as long as the exchange is properly structured from initiation and the regulations governing improvement exchanges are followed. The regulations do not permit the investor to take title to the improved property and thereafter make improvements. Improvements made after the investor acquires title to the replacement property will not be considered like-kind property when determining the amount an investor has reinvested in the 1031 exchange. The 1991 Treasury Regulations and Rev. Proc. 2000-37 established parameters for "safe harbor" improvement exchanges outlined below.

In a delayed or forward exchange, an investor is entitled to a maximum of 180 calendar days from the date of sale of the relinquished property to acquire all replacement property and spend all of the proceeds required to defer all desired capital gain taxes. This is also the case when performing an improvement exchange. However, all improvements do not need to be completed during this period. The final value of the replacement property is the combination of the replacement property purchase price plus the capital improvements made to the property with the 180 day exchange period.

In addition, in an improvement exchange, the property to be improved must be parked with an Exchange Accommodation Titleholder ("EAT") established by the Qualified Intermediary. The EAT holds title to the replacement property during the exchange and while improvements are being made. A significant amount of structuring and documentation is involved in properly completing an improvement exchange so the use of an experienced Qualified intermediary and the involvement of the investor's legal and tax advisers is essential.

Further, in an improvement exchange, the 180 calendar day period runs from the earlier of the closing of the sale of the relinquished property or the parking of the replacement property with the EAT in a reverse improvement exchange. Title to the parked property is transferred to the EAT and not the investor. Thus, in structuring improvement exchanges, investors should be aware that any delay between the sale of the relinquished property and the purchase of the replacement property to be improved will reduce the 180 day period in which improvements can be made. Savvy investors will generally ensure that their sale and purchase are relatively close in time or will first purchase the replacement property to be improved and structure the exchange as a reverse improvement exchange. Many investors also ensure that all permits are in place before closing on the replacement property or they risk that there will be little or no time remaining in their 180 day

exchange period by the time permits are obtained. One final note is that investors performing an improvement exchange would be wise to obtain an architect's or contractor's certificate of completion at the end of the 180 day exchange period and to take photographs of the stage of completion to substantiate what improvements were made during the exchange in case of an audit. No credit is permitted for prepaid fees for work performed after the expiration of the 180 day period.

While it is essential to engage a competent Qualified Intermediary to facilitate an improvement exchange, these types of exchanges can provide significant tax benefits to investors. Improvement exchanges can be used for ground up improvements, refurbishing facilities, complete gut renovations and for build-to-suit projects for owner-users. With proper planning, improvement 1031 exchanges can result in significant tax savings.

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