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1031 Exchange: Using the improvement exchange for “already-owned” property - by Lynne Bagby

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As sectors of the US economy continue to improve, some New England companies and business owners would like to expand their footprint or open more locations. Some own property adjacent to their facility or own property in another location where they'd like to expand their business. The question is “what-to-do?” when it is well established that an Exchanger cannot include improvements to a property that they already own as replacement property in a 1031 exchange.

In a typical improvement exchange, the Exchanger uses a Qualified Intermediary (QI) to sell its relinquished property. An affiliate of the QI, an Exchange Accommodation Titleholder (EAT), uses the proceeds from this sale to purchase a new replacement property from a third-party seller, improve the property, and transfer improved property to the Exchanger within 180 days after the day the relinquished property was transferred.

The use of the EAT and QI, in this manner, allows the Exchanger to control the property and improvements built thereon. Because the EAT is treated as owning the property for federal income tax purposes, however, the Exchanger is able to reinvest the proceeds from the sale of the relinquished property in the land and improvements tax-deferred. This creates greater tax deferral than the Exchanger would obtain if only the land had been the replacement property.

Reiterating the statement that “an Exchanger cannot improve property they already own as replacement property in a 1031 exchange”, the IRS released Private Letter Rulings 200251008 and 200329021, which set forth structures where an EAT made improvements to a property owned by an affiliate or related party and then the Exchanger received the improved property as qualifying replacement property.

Although these two rulings* do not have identical circumstances, they do share a similar approach:

1. Exchanger enters into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT and enters into an exchange agreement with a QI;
2. Exchanger's affiliate or related party leases the replacement property to EAT at fair market rent, for a term of not less than 30 years, as part of the QEAA as defined in Revenue Procedure 2000-37;
3. Exchanger (or a third-party bank where the Exchanger gives its personal guaranty) lends EAT the funds needed to construct improvements on the leased property;
4. Exchanger assigns its rights to the sale contract of the relinquished property to the QI;
5. Exchanger transfers title to the relinquished property to the buyer;
6. Exchanger assigns its rights in the QEAA to the QI;
7. QI uses proceeds from the sale of the relinquished property to pay EAT;
8. EAT uses the proceeds received from the QI to pay for improvements and/or to pay the construction loan in full; and

9. QI directs EAT to transfer the improved replacement property directly to the Exchanger.
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