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Purchasing replacement property from a builder in a 1031 Exchange - by Lynne Bagby

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With all of the development and new construction happening throughout New England, many real estate investors are interested in taking advantage of opportunities to purchase new construction directly for investment or as replacement property in a 1031 exchange.

Therefore, when a taxpayer considers purchasing new construction from a builder as replacement property in a 1031 exchange, they should be aware of various factors in advance of the 1031 exchange transaction.

The delayed exchange rules allow taxpayers up to 180 calendar days to purchase replacement property. This time frame is statutory and only property properly identified within 45 calendar days and acquired within 180 days qualifies as like-kind replacement property in a 1031 exchange. Taxpayers should be aware there are no provisions providing for construction delays or other factors where a builder may not be able to deliver replacement property to a taxpayer within the 180-day time deadline. A reasonable approach might be for the taxpayer to negotiate for the builder to close on the sale of the replacement property a little in advance of the actual 180th day to provide margin for any potential last-minute issues that could potentially push back the actual closing date.

If a builder has a lender funding their construction project, often the lender will not allow the builder to transfer a property to the 1031 exchange buyer until they have a “Certificate of Occupancy.” Taxpayers should discuss these and other issues with the builder prior to entering into a contract to make sure there will not be challenges on the builder’s side of the transaction that might negatively impact the ability of the builder to transfer the newly constructed replacement property to the taxpayer within the 180-day exchange period time deadline.

To qualify for 1031 tax deferral, the taxpayer must receive like-kind real property, not services to be produced any time after the expiration of the exchange period. Any exchange proceeds that are not reflected in actual improvements to real property within the 180-day exchange period are considered boot since production services to be built in the future are not like-kind real property. The Treasury Regulations specifically states the following: "…is not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of like-kind."

Additionally, with regard to the identification of real property to be produced,

The Treasury Regulations also state: "Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name." Accordingly, the taxpayer should make sure that they unambiguously describe replacement property which will normally be something like an actual street address or the specific address and property unit number. If the replacement property consists of property to be produced, in addition to meeting the foregoing requirements, the taxpayer must identify the real property and the improvements to be constructed in as much detail as is practicable at the time the identification is made.

It is important that taxpayers doing 1031 exchanges seek advice from their tax and/or legal counsel to be sure that any contracts they enter into with a builder for a replacement property do not put them at risk of potentially violating the 1031 exchange rules and Treasury Regulations.

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