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Can you use exchange funds for improvements?- by Bill Lopriore

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Bill Lopriore

A 1031 exchange is a great tool for exchangers who want to avoid paying tax on the gain from the sale of real estate. However, in order to completely defer the tax, an exchanger must find one or more replacement properties with a total fair market value that equals or exceeds what is being sold, and must use all the cash from the relinquished property and invest it in the new property. Many exchangers don't realize that a build-to-suit exchange can give them more flexibility in structuring their 1031 exchange to meet these requirements.

A build-to-suit exchange allows an exchanger to use the proceeds from the sale of the relinquished property to acquire and to improve the replacement property. In this arrangement, the relinquished property is disposed of and the sale proceeds go to the qualified intermediary (the "QI"). The exchanger must identify what is to be acquired within 45 days, including a description of the improvements. The QI or its affiliate acquires the property using the exchange funds. The exchanger manages all construction and periodically sends invoices to the QI, who pays them using exchange funds. The replacement property is transferred from the QI or its affiliate to the exchanger once any one of the following conditions are met: construction is completed, enough value is added to the replacement property to qualify for full tax deferral, or the 180-day window expires.

Bill Lopriore is the northeast regional manager and counsel for First American Exchange Company, LLC.

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