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Improvement exchanges can raise some issues

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In an exchange, the taxpayer must acquire replacement property of equal or greater value than the relinquished property to fully defer taxable gain. An Improvement exchange (also known as a build-to-suit or construction exchange) is one way of increasing the value of replacement property for an exchange. Replacement property value is generated in an amount equal to the cost of improvements that can be invested into and become real estate while the property is parked with an exchange accommodation titleholder (EAT).

Improvement exchanges raise the following issues: 1. Dealing with limitations caused by the forward exchange 180-day limit; 2. Investing sufficient value in the replacement property during the limited time available; 3. Documenting the amount of construction expenses; 4. Establishing that construction expenses became part of the real estate; 5. Using exchange proceeds to fund improvements to the replacement property; 6. Identification of replacement property in the "forward exchange" portion of the exchange; and 7. Using land owned by the taxpayer or a related party as replacement property.

Time Limitations: The Revenue Procedure allows an EAT to hold property for up to 180 days. If the taxpayer starts a forward exchange, the period of time elapsed on the forward exchange will decrease the amount of time to park the replacement property.

Sufficient Value: The 180-day limit makes getting enough value into the replacement property a challenge. Some properties, such as industrial properties, can be constructed in 180 days. Permitting and site work are time consuming and generate little increase in real estate value.

Construction Expenses: In a reverse exchange, the EAT is considered the owner of the replacement property. The EAT borrows the acquisition cost of the land as well as the cost of improvements. The EAT must track these expenses for tax purposes as each construction advance is made. Often, forms like AIA Form G-702 are used to approve construction advances.

Relinquished Property Funds: Taxpayer cannot receive, pledge, borrow, encumber, or otherwise receive the benefit of the exchange proceeds before the end of the exchange period. The use of exchange funds to satisfy the taxpayer's obligations on a pre-existing construction contract may be considered as giving the taxpayer the benefit of the exchange funds.

Identification: If the exchange is not completed during the 45-day identification period, the taxpayer must identify the replacement property in a forward exchange. The regulations require that the underlying land be particularly described, and that the improvements be described in as much detail as possible at the time of identification.

Taxpayer or Affiliate-Owned Land: This is a hot issue. In Rev. Proc. 2004-51, the IRS stated that a transaction in which the taxpayer owned land, leased land to the EAT upon which EAT constructed improvements, and which the EAT transferred to the taxpayer as replacement property is outside the Rev. Proc. 2000-37 safe-harbor.

Conclusion: Using exchange proceeds in appropriate situations may be significantly more attractive than obtaining a construction loan from a third party lender. In situations presenting complicated tax and legal issues, a sophisticated intermediary like Compass demonstrates its value through its ability to help you plan and complete transactions like Improvement exchanges.

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