Can Property Improvement Costs Be Part of a 1031 Tax Deferred Exchange?

What is a build-to suit or 1031 improvement exchange?

Often a taxpayer will sell his old property (the relinquished property) for a greater value than the cost of purchasing the new property (the replacement property). If nothing further is done, the excess value that is not reinvested is taxable and referred to as "boot" in the context of an Internal Revenue Code (IRC) 1031 exchange. However, if the new property is land to be constructed upon (a build-to-suit exchange) or consists of land with a structure on it that needs further improvements (a property improvement exchange), it is possible for the improvement costs to be incurred prior to the exchange. As is the case with many IRC §1031 procedures, there are safe harbor provisions which must be closely adhered to. Many people assume that so long as the taxpayer uses exchange proceeds to acquire the new property and makes the improvements within the 180-day window for an exchange, the taxpayer can include the cost of the improvements into the value of the new property. However, IRC §1031 regulations require a valid exchange to consist of like-kind properties being exchanged. Hiring a contractor or other service provider and paying for labor and materials is not like-kind to the sale of real estate. As expressed by the IRS the problem is as follows:

"The transfer of relinquished property is not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for 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 a like kind." (Reg § 1.1031(k)-1(e)(4)).

The exchange regulations became effective in 1991. Approximately ten years later, in 2001, the IRS issued Revenue Procedure 2000-37 part of which dealt with this situation. The IRS came up with the idea of a Qualified Exchange Accommodation Titleholder, an entity able to work around the issue of improvements not being like-kind to the taxpayer's old property. Revenue Procedure 2000-37 refers to this entity as an "Exchange Accommodation Titleholder," now commonly called an EAT.

There are many companies that act as qualified intermediaries for conventional forward exchanges, and a limited number of those companies are also set up to provide EAT services. Selecting a knowledgeable qualified intermediary is critical to the success of the transaction (Read why in my recent discussion about the Case of Kreisers Inc. v. First Dakota Title Limited Partnership).

How does the use of an EAT help in an exchange involving improvements?

The EAT can acquire title to the new property on behalf of the taxpayer and to "park" it until the improvements are in place (but in no event beyond 180 days). Once the EAT transfers ownership of the property to the taxpayer, the taxpayer has acquired improved real estate, which then includes the value of the improvements that were made during the parking period. For the mutual benefit of the taxpayer and the EAT, it is customary for the EAT to take title to the property using a special purpose entity, usually a limited liability company (LLC). This insulates the client's exchange transaction from other clients' transactions as well as from the affairs of the exchange company acting as the EAT.

What's the difference between how forward and reverse build-to-suit or improvement exchanges are structured?

A build-to-suit or improvement exchange can take two different forms. The first occurs when the taxpayer has sold property and funded the exchange account prior to the acquisition date of the new property. The exchange funds can pass to the EAT to cover the purchase price of the new property. The balance of the funds are given to the EAT as necessary to cover the costs associated with making the improvements. This is known as a forward build-to-suit or property improvement exchange.
If the taxpayer wants to begin the improvements before the sale of the old property, a reverse build-to-suit or property improvement exchange is necessary, since the sequence of buying (by the EAT) and selling is "reverse" from a normal exchange. In the case of a reverse transaction, since the exchange account it not yet funded, funding of the purchase price and improvements needs to be provided to the EAT from a bank or taxpayer loan or sometimes both. These loans get paid back at the conclusion of the transaction when the exchange funds are used by the taxpayer to acquire the property from the EAT.

Do all of the improvements need to be made during the 180-day parking period?

It is not necessary for the improvements to be completed during the parking period, however the taxpayer only gets credit for the value of the land and improvements that are in place at the time the taxpayer takes direct ownership. The taxpayer can make additional improvements after the exchange has taken place.

What flexibility does Revenue Procedure 2000-37 allow in a build-to-suit or property improvement exchange?

Revenue Procedure 2000-37 contains some very taxpayer friendly provisions including:

- The terms of any build-to-suit/property improvement contract between the taxpayer and EAT do not have to be at arm's length.
- The taxpayer may loan funds directly to the EAT.
- The taxpayer is permitted to guaranty any bank loan made to the EAT.
- The taxpayer may indemnify the EAT for costs and expenses incurred.
- The taxpayer or a "disqualified person" (generally an agent of the taxpayer) may advance funds to the EAT.
- The property may be leased by the EAT to the taxpayer during the parking period.
- The taxpayer may act as the contractor (and receive a fee) or supervise the making of the improvements.

In a reverse build-to-suit/property improvement exchange, at some time during the parking transaction (but no later than 180 days) the old property gets sold and the net proceeds go into the taxpayer's exchange account. No later than 180 days from the inception of the parking transaction, the exchange funds are sent to the EAT as the nominal seller and the EAT uses these funds to repay the original bank and/or taxpayer loan.

The procedure is much the same for a forward build-to-suit/property improvement exchange where the exchange account has been funded prior to the parking transaction. In this case, although the funds may have been paid out to the EAT, the taxpayer still needs to complete the conventional exchange by acquiring the improved property from the EAT.

Whether it is a forward or reverse build-to-suit exchange, completing the transaction is the same. The taxpayer's rights under the contract to acquire the improved property from the EAT are assigned to the qualified intermediary, and the transfer to the improved property is accomplished by either assigning the membership interest in the EAT to the taxpayer or by the EAT issuing a deed to the taxpayer.

Customary agreements that would be used to document this type of exchange include:

- Qualified Exchange Accommodation Agreement (required under Revenue Procedure 2000-37)
- Assignment by the taxpayer to the EAT of the purchase contract for the new property
- Loan documents between the EAT as borrower and the lender
- Master Lease if the property has a tenant or tenants
- Sale Contract for the sale of the property from the EAT back to the taxpayer
- Environmental Indemnity Agreement