



## IMPROVEMENT EXCHANGES

### OVERVIEW OF AN IMPROVEMENT EXCHANGE

Internal Revenue Code Section 1031 and Regulations issued by the Internal Revenue Service provided investors with a detailed "safe harbor" procedure to exchange real property and defer payment of capital gains taxes. By using an "Improvement Exchange," it is possible for an investor to receive property in a tax-deferred exchange that is renovated or built-to-suit to the investor's specifications. However, as explained below, an Improvement Exchange must be structured and executed carefully to comply with applicable statutory, regulatory, and case law.

The principal advantage of an Improvement Exchange is that an investor can use "tax-free dollars" to improve or repair the desired property. In order to achieve a fully deferral of capital gains taxes, the "Exchange Value" of the "Replacement Property" to be received by the investor (the purchase price plus closing costs) must equal or exceed the "Exchange Value" of the "Relinquished Property" given up by the investor in the exchange (the sales price less closing costs). Because the Exchange Value of the Replacement Property is determined as of the date that the investor receives title, only the value of any improvements made to the Replacement Property prior to its conveyance to the investor may be included in its Exchange Value. Therefore, in an Improvement Exchange, the exchange proceeds from the sale of the Relinquished Property may be used to acquire, and repair or improve, the Replacement Property without paying capital gains taxes on such proceeds.

### REQUIREMENTS FOR AN IMPROVEMENT EXCHANGE

To achieve the desired tax-deferred treatment, an Improvement Exchange must meet certain requirements. Under the Regulations, in all tax-deferred exchanges the investor must receive the Replacement Property within 180 days of the date the Relinquished Property is conveyed to the purchaser. The Regulations further provide that, for the value of the improvements to be included in the Exchange Value of the Replacement Property, such improvements must be completed prior to the investor's receipt of such property. For example, prepaying the costs of improvements that will be completed after conveyance of the Replacement Property to the investor is not "completion" under the Regulations, and such costs cannot be included in the Exchange Value. Therefore, for improvements to be included in the Exchange Value of the Replacement Property, such improvements must be completed, and the property conveyed to the investor on or before the 180th day.

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### STRUCTURE OF AN IMPROVEMENT EXCHANGE

An Improvement Exchange using a qualified intermediary may be structured as follows:

One of the most critical components of an improvement exchange is the existence of the titleholder LLC, a special purpose entity owned by Legal 1031. The special purpose LLC holds title to the real estate for up to 180 days or until the improvements are completed. The function of the LLC is



necessary because the exchanging taxpayer is unable to receive title to the property until the final step of the improvement exchange.

To complete a reverse or improvement exchange, ownership is transferred to the exchanging taxpayer either by assignment and assumption of the LLC membership interests, or through a deed transfer. Only the value of improvements completed and affixed to the real property on the date it is transferred back to the exchanging taxpayer can count towards the exchange value.

The investor and the qualified intermediary enter into a comprehensive Exchange Agreement specifying the qualified Intermediary's obligation to acquire certain property, improve the property to the investor's specifications, and convey the improved property to the investor in exchange for the Relinquished Property. The contract to sell the Relinquished Property is assigned by the investor to the qualified intermediary, and the property is sold with the sales proceeds going to the qualified intermediary. The Replacement Property and the specific improvements to be made are often identified in the Exchange Agreement but can be identified up to 45 days after closing.

The contract negotiated by the investor to acquire the identified property is assigned to the Qualified Intermediary, who then purchases and takes title to such property. After acquisition of the identified property, the Qualified Intermediary and the investor cooperate in the construction of the improvements. The investor is responsible for taking the steps necessary to construct the improvements, including retaining the design professionals, contractors, and other persons necessary to complete the project, negotiating all construction contracts, arranging for the construction financing, and supervising the construction. The Qualified Intermediary is a party to the construction contracts, and jointly approves disbursements of the exchange proceeds and other construction funds.

The sources for funding the acquisition and construction costs usually include the exchange proceeds, the proceeds of construction financing from an institutional lender, and/or funds lent by the investor to the Qualified Intermediary. Construction financing is usually made to the Qualified Intermediary on a nonrecourse basis and is secured by the Replacement Property. The construction financing may also be guaranteed by the investor if required by the lender.

Upon completion of the improvements (or when the 180-day exchange period is about to expire), the Replacement Property is "sold" by the Qualified Intermediary to the investor at a price equal to the acquisition cost plus the construction cost of the completed improvements. The exchange is completed when the Replacement Property is conveyed to the investor.

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