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How You Can Build Yourself the Perfect Replacement Property

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Timing and location are two major components of any successful real estate transaction. Taxpayers contemplating a 1031 exchange will begin their search for replacement property well before listing

their relinquished property for sale. If they cannot find the right property, they may elect not to sell. The taxpayer, however, doesn't have to find the perfect replacement property; it can purchase vacant land or a dilapidated structure and improve the same. If structured properly, a construction exchange will qualify for tax deferred treatment under Section 1031 of the Internal Revenue Code (IRC).

General Rules

Like conventional 1031 exchanges, construction exchanges can be simultaneous or deferred, forward or reverse. Most of the same rules will apply. There are, however, some significant differences.

1. *Agency:* Due to the magnitude and complexity presented by most construction projects, issues of control concern many taxpayers. IRS rulings and case law have provided that a taxpayer may remain actively involved in the construction process without jeopardizing the exchange (see Section 4 below). In order to fully defer its gain for 1031 purposes, however, the taxpayer cannot take title to the property until construction has progressed to a point where the value of the replacement property equals or exceeds the value of the relinquished property.

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Agency issues arise if the taxpayer causes a related party, its contractor, or its "agent" to take title to the replacement property during the construction period. The IRS can assert that the taxpayer's level of control over the other party is such that the taxpayer is in constructive (or actual) receipt of exchange proceeds. If the IRS is correct, the transaction will not qualify for 1031 deferral.

It is advantageous to utilize the services of a qualified intermediary because a qualified intermediary is presumptively deemed not to be the agent of the taxpayer. Treasury Regulations specify that a qualified intermediary is not the agent of the taxpayer if the intermediary otherwise is qualified and the exchange agreement between the taxpayer and the intermediary expressly limits the taxpayer's access to proceeds being held by the intermediary.

2. *Identification of the Replacement Property:* A transfer of relinquished property in a deferred exchange will not fail to qualify under section 1031 merely because the replacement property is not in existence or is being constructed at the time the property is identified as replacement property. When identifying replacement property to be built, taxpayers must provide the legal description for the land and as much detail regarding construction of the improvements as is practicable, including providing detailed plans and specifications for the improvements.

In determining whether the replacement property received by the taxpayer is substantially the same property as identified, variations due to usual or typical construction changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified, and the exchange will fail. A taxpayer should be able to avoid this possible trap by considering various alternative building designs prior to the exchange and identifying in the exchange the chosen alternative.

The identification should contain as much detail as possible so that minor variations in the completed project can be classified as "usual and typical construction changes."

If the taxpayer decides to construct a substantially different structure prior to the expiration of the identification period (45 days), then the original identification can be revoked.

3. *Receipt of Replacement Property:* The fact that the construction of the replacement property may not be complete at the time of the exchange will not, in itself, cause the replacement property to be considered a substantial variation from the property identified, so long as the taxpayer would have received substantially the same property had the construction been completed. There is no requirement, for instance, that a certificate of occupancy be obtained before the exchange can be consummated. Once title is taken to the land by the taxpayer, however, the exchange is completed and any further disbursements of exchange proceeds are considered "boot" – taxable gain to the taxpayer.

If the construction on the replacement property cannot be completed within the exchange period, the exchange may still go forward, but the exchange value of the replacement property will only include the land and construction work completed prior to its receipt. Accordingly, if the net proceeds of the sale of the relinquished property are completely expended on the construction prior to the end of the 180 day exchange period, then the exchange may be consummated even though the construction is incomplete, subject, of course, to the liability netting rules (any debt on the relinquished property should be matched by an equal amount of debt on the replacement property to avoid taxable boot). Improvements constructed after the taxpayer has acquired the replacement property do not qualify as like-kind replacement property.

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The installed improvements should be documented by photographs and affidavits of completion both at the date of acquisition and the date of substantial completion. This will confirm that the exchange proceeds were expended on legitimate construction expenses. State law will govern exactly how much of the unfinished project will be considered replacement property. Uninstalled fixtures such as cabinets, sinks, toilets and the like are unlikely to be considered real property under state law, and therefore will be considered as non-like-kind boot in the exchange. Similarly, construction labor occurring after the taxpayer receives the replacement property will not be considered like-kind property in the exchange, even if prepaid. Prepayments to the taxpayer's general contractor for work to be performed after the 180 day period also are not allowed.

4. *Control over the project:* The taxpayer is not totally precluded from participating in the construction process. In various letter rulings by the IRS and relevant case law, the following actions have been permitted in

connection with construction exchanges: (i) the taxpayer may supervise construction of the improvements, (ii) the taxpayer may review and approve payment of invoices/draw requests, (iii) the taxpayer may provide funds to finance the construction of the improvements; (iv) the taxpayer may agree to be responsible for cost overruns, and (v) a party related to the taxpayer may act as the contractor in building the improvements.

The taxpayer can exert even greater control over the project, even acting as the general contractor (and receiving payments from the qualified intermediary) provided the taxpayer does not make a profit in that role, if the construction exchange is structured to comply with the safe harbor provisions of Revenue Procedure 2000-37.

Reverse Construction Exchange: If the replacement property is the taxpayer's future office or business location, the taxpayer may require that the construction of replacement property be completed before the disposition of the relinquished property. This scenario is known as a reverse construction

exchange since the construction of the replacement property will occur prior to the sale of the taxpayer's existing facility. Revenue Procedure 2000-37 describes a safe harbor for reverse construction parking arrangements if certain requirements are met.

Financing the acquisition of the replacement property and construction of the improvements may present difficulties. The financially independent taxpayer will loan the necessary funds to qualified intermediary securing the loan with a mortgage on the replacement property. Many commercial lenders, however, will be apprehensive of the parking arrangement, and will require personal guarantees from the taxpayer securing those guarantees with mortgages on the relinquished property or other property owned by the taxpayer. Such security arrangements will not disqualify a safe harbor exchange.

If a reverse construction exchange cannot be completed by the end of the 180 day safe harbor period, the transaction can be structured as a non safe harbor exchange. ■