 Search Articles

Commercial Investment Real Estate

January/February 2002

Internet links are at the end of the article, in the order they appeared in the article.
Article has 9 pages.

Constructing an Exchange

After Surveying the Opportunities, Exchangers Should Consider Building Their Replacement Properties.

by Ronald L. Raitz, CCIM, and Bridgette M. Raitz, CPA

Internal Revenue Code Section 1031 tax-deferred exchanges on investment real estate are now quite commonplace; however, in certain situations a normal delayed exchange won't work due to timing or value problems. To avoid losing the tremendous tax benefits of an exchange, investors should consider several techniques that have been developed to allow some additional flexibility.

In typical tax-deferred exchanges, an investor sells a piece of investment real estate (the relinquished property) and must buy another (the replacement property) within 180 days. A qualified intermediary handles the mandatory exchange mechanics, and the exchange is completed when the investor takes title to the replacement property.

However, problems can arise when investors want to make improvements to a replacement property. To get credit for the value of the improvements, they must be in place *before* an investor takes title, which can be quite a challenge.

A construction exchange can accomplish this goal. With this technique, investors can construct a replacement property — even on land they already own — and still defer taxes indefinitely into the future.

Why Use a Construction Exchange?
If investors cannot find a suitable replacement property, they may give up on the possibility of an exchange and even walk away from deals without knowing that a construction exchange may be the ideal solution for their circumstances. Commercial real estate professionals should be aware of the following situations in which investors could consider a construction exchange.

No Existing Property Is Suitable. Unable to find a property that meets their needs, investors may choose to build a replacement property. Typically, an investor must close on the replacement lot prior to making any improvements, and once title to the lot is received, the exchange is considered complete. (In this scenario, the investor is not buying multiple investment properties.) The cost of the replacement lot usually is less than the net sales price of the relinquished property, giving rise to a taxable gain. Further, investors may not use remaining exchange proceeds to build improvements on the acquired lot without triggering recognition of gain on those proceeds.

For the value of the improvements to count toward the exchange, they must be in place on the lot prior to investor acquisition. These improvements also must be considered real property under local law. The challenge is finding a way to improve the lot prior to taking title to it.

Major Improvements Are Required. Investors may be interested in buying replacement properties that need substantial improvements. The acquisition price, prior to making improvements, may be less than the target price needed to maximize the full tax benefits, so investors face the same challenge — how to make improvements before acquiring the eventual replacement property.

For example, Ryan, who owns a carpentry shop that has outgrown its present location, finds a larger shop that will require extensive renovation and improvements. Ryan recently received an offer of $500,000 on his current site; he estimates that he can buy the new property for $350,000 and needs to add improvements worth another $250,000. To fully defer the gain he would have on the sale of his existing facility, he needs to have at least $150,000 of the improvements in place before he takes title. A construction exchange may be the strategy he needs to maximize his exchange benefits.

The Replacement Property Is Built on Investor's Land. When investors want to build replacement properties on land they already own, a construction exchange is an ideal solution. By using this method, they can construct improvements without having them immediately attach and become a part of the real property. An investor can use a long-term ground lease to lease land to a third party until the replacement property is constructed.

Facilitating the Process

If investors cannot take title to the target replacement lot before improvements are made, they must safely "park" the property while it is being improved. Most investors choose one of the two following options.

• They create a separate entity specifically for this purpose. A professional service provider or QI firm usually uses a single-member limited liability company to perform this specific parking service. This entity only performs the parking/improvement function, with the QI service handled separately. The new parking entity may not be either a related party or what is termed a disqualified person — anyone who has provided accounting, legal, real estate, or investment banking services or anyone who has been employed by the investor during the previous two years.

• They may use a QI. This choice is similar to the separate entity; in this variation, however, the new entity provides *both* the QI and parking functions.

Other less-common alternatives include the following:

• An investor uses the contractor who is building the improvements. Although this alternative may be interesting in theory, many contractors have neither the financial ability nor the desire to take title to the lot. Further, investors may have concerns about lending money to the contractor for the improvements.

• An investor relies on a trusted, unrelated individual. Unfortunately, the additional work associated with the task may make this a relatively onerous burden for even a good friend. Additionally, unforeseen events such as death, bankruptcy, and assets frozen due to divorce or other litigation may inadvertently derail an exchange or friendship or both.

• The seller of the lot holds the property. Although some sellers may be willing to accommodate this request in order to sell their property, most would prefer to sell it outright. Many investors also are hesitant to make substantial improvements to property still owned by another individual or entity.

Executing an Exchange

Assuming that a QI is used to acquire the lot, a construction exchange would adhere to the following procedure. The investor enters into a construction exchange agreement with the QI to provide the construction exchange service. The QI sets up a separate entity to act as both the QI and the parking entity. The relinquished property is sold using the typical direct deeding process, and the QI holds the proceeds. (See Handling Relinquished Property.)

The QI takes title to the lot using the exchange proceeds for the purchase. If additional funds are needed, they are borrowed from the investor or a third-party lender.

A construction management agreement is executed, with the investor or someone he designates serving as the construction manager. The investor/construction manager makes written requests for funds to the QI or the third-party construction lender. The money goes directly to the contractor and never to the investor.

By the 45th day following the relinquished property closing, the investor submits a detailed identification letter to the QI that includes a legal description of the land and a detailed description of the anticipated final improvements.

The improved property is transferred to the investor either at the end of 180 days or when the value of the improvements and lot equals or exceeds the target replacement value.

Building on Land Already Owned
Building a replacement property on land an investor already owns still can provide the benefits of an exchange. To be successful, the exchange must separate the ownership of the land from facilitation of the improvements. Typically, this may be accomplished using a long-term ground lease.

In many commercial real estate transactions, a property user may want use of a site but have no desire to own it. This user leases the ground from the owner and, under the terms of the ground lease, is allowed to construct leasehold improvements. The improvements, along with the lease, are considered an asset to the lessee. If the lessee wants to sell this interest to another party, the buyer will enjoy the use of the property under the lease and the leasehold improvements for the balance of the term. This type of lease is considered like-kind with real property if the term of the lease is 30 years or longer.

For example, Michael and Kathy own a piece of land that has been in his family for years. After receiving an unsolicited offer on a shopping center they own, they start looking for suitable replacement properties. Finding no land available at a reasonable price, they decide to build a retail center on the property they already own. Their tax professional suggests structuring a construction exchange that would allow them to defer the significant gain that would result if they didn't exchange.

To accomplish this type of exchange, a professional service provider establishes a separate entity that offers both the QI and parking functions, referred to as the QI entity. The relinquished property is sold, and the QI entity holds the proceeds. The QI entity then would enter into a ground lease for 30 years or more with Michael and Kathy and hire them as construction managers to supervise the leasehold improvements. Once these improvements equal the target replacement value or the 180-day acquisition deadline has arrived, the QI entity would transfer the leasehold interest in the property along with leasehold improvements to them as the replacement property. If the QI entity is a single-member LLC, the exchange could be concluded by selling 100 percent of the membership interest to the investors.

Reverse Construction Exchanges

What if the value of the lot and the improvements that can be made within 180 days fall considerably short of the targeted replacement value? Or, what if the replacement lot must be purchased before the relinquished property can be sold?

If the tax consequences are significant, investors might consider a reverse construction exchange. Under this hybrid exchange technique, a parking entity acquires the replacement lot prior to the sale of the relinquished property and begins construction of the desired improvements. The closing of the relinquished property is scheduled to allow enough time for the needed improvements to be in place within 180 days.

If the entire process — from the purchase of the replacement lot to the final closing — is 180 days or less, it is deemed a safe-harbor exchange and is afforded protection under recently released Revenue Procedure 2000-37.

For example, Nicole wants to build her own replacement property. Unfortunately, she must close on the lot prior to completing the sale of her relinquished property. She hires a QI firm to provide the services needed to complete a reverse construction exchange.

On January 1, the QI's new entity purchases the replacement lot for $400,000. Construction, which is expected to take 5½ months and cost an additional $1.7 million, begins almost immediately. Nicole has arranged for the QI entity to have construction financing totaling $2.1 million from her local bank. On April 15, her relinquished property sells for $2 million and funds are forwarded to the separate QI entity. The improvements are in place by May 15 and the property is transferred to her on May 20, completing the exchange. (See Reverse Construction Exchange.)

If the reverse exchange exceeds 180 days, the transaction does not have safe-harbor protection. Accordingly, this type of exchange bears an additional level of tax risk. Without the safe-harbor protection, there are several things to consider. Due to potential agency issues, it is important that the new entity provide only the parking function; the QI service should be provided by a different entity. Also, because the relinquished property has not been sold, the investor must have the financial strength to fund the acquisition and construction of the eventual replacement property from sources other than the relinquished property proceeds. Finally, some tax professionals believe the parking entity should be exposed to more real-life burdens and benefits. They suggest that the parking entity contribute capital to the acquisition or sell the property to the investor at a fair-market value as opposed to a set price formula.

Construction exchanges require additional planning and effort. The cost of these transactions usually is four to five times greater than regular exchanges, but the final results can be extremely worthwhile. Because it is often difficult to find a suitable replacement property, this technique alleviates the pressure of finding appropriate property within the 45-day identification period and potentially can make use of land that an investor already owns.

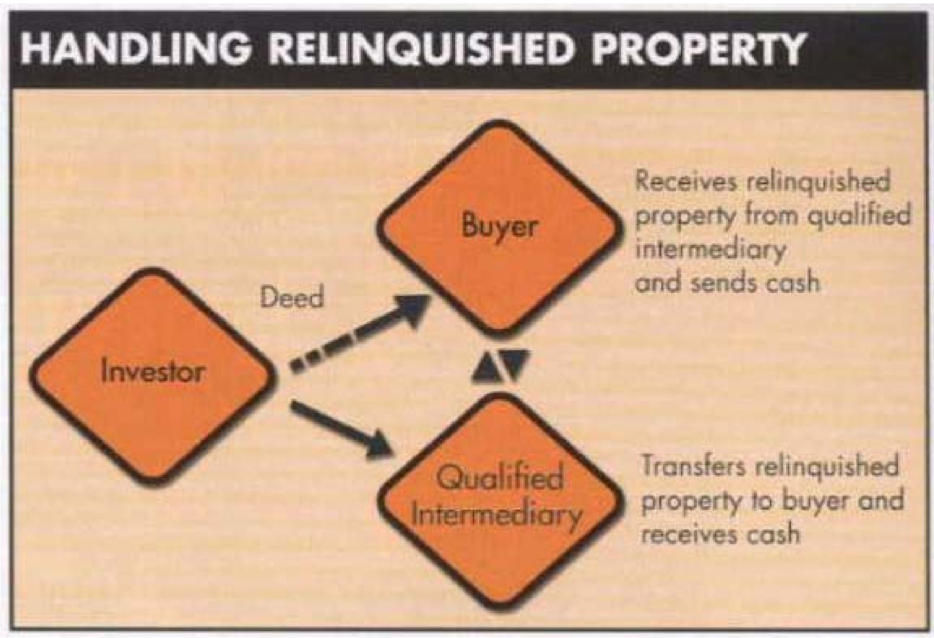
Under the appropriate circumstances, a construction exchange may be the perfect way for clients to meet their investment goals. But, as with all transactions requiring technical guidance, it is important to exercise care when selecting a qualified service provider. Any plan also should involve input from the investor's tax professional.

Ronald L. Raitz, CCIM, is president of Real Estate

Exchange Services in Marietta, Ga., which provides a full range of services for 1031 tax-deferred exchanges. He serves on the Board of Directors of the Federation of Exchange Accommodators. Bridgette M. Raitz, CPA, is an accountant with 16 years of commercial real estate experience . Contact them at (770) 579-1155 or rraitz@rees1031.com.

Commercial Investment Real Estate

January/February 2002



Commercial Investment Real Estate

January/February 2002

| *CIRE* Home | Subscriptions | Back Issue/Article Orders |
| Editorial | Advertising | Copyright |