IMPROVEMENTS ON REPLACEMENT PROPERTIES

An Exchangor may want to rehabilitate or construct improvements on a Replacement Property in order to increase its value to match the value of the Relinquished Property.

This presents problems given the time constraints of a Delayed Exchange. Any improvements paid for with exchange funds must be completed within 180 days of the closing on the Relinquished Property and before the transfer of the Replacement Property to the Exchangor. The Regulations treat improvements made with exchange funds after the Exchangor has closed on the Replacement Property as construction services, which are not like-kind.

The acquisition of the Replacement Property by the Exchangor can be viewed as a "snapshot" which froze the funds in the exchange account and the cost of the Replacement Property as well. Funds left in the exchange account after the "snapshot" closing date no longer can qualify for tax-deferral, even if the funds are spent to improve the Replacement Property after closing.

One practice is to convince the Replacement Property Seller to construct the improvements within the 180-day period with the Seller's own funds and raise the sales price of the Replacement Property. If the Seller is reluctant to use the Seller's own money, the Facilitator may advance the Seller the required funds through secured loans out of the exchange funds. Alternatively, it may be possible to amend the Sale Agreement and give the Intermediary the authority prior to closing to enter the property and make improvements with the exchange funds. There is obvious business risk associated with this.

If the Seller is unwilling to construct improvements on the Replacement Property, the Facilitator may acquire the Replacement Property and then construct the improvements with exchange funds **prior to** transferring the Replacement Property to the Exchangor. The Final Regulations require that the Exchangor identify the proposed improvements with as much detail as practicable, prior to the end of the 45-day identification period. What is built must be substantially the same as the improvements described in the identification and designation document.

The Facilitator will probably want to establish a special purpose limited liability company to acquire the Replacement Property to be improved and enter into a Qualified Exchange Accommodation Agreement satisfying the requirements of Rev. Proc. 2000-37 (see Rules for Reverse Exchanges handouts).

Exchange Facilitator Corporation
2627 Eastlake Ave. E. Seattle WA 98102 206-324-1350 FAX 329-6801

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Careful structuring of this arrangement is essential. Any construction contracts should be between the Facilitator and the contractors. Bills for the improvements should be made out in the name of and paid by the Facilitator.

An **unrelated** Third Party, other than a Facilitator company, could acquire the Replacement Property, construct the improvements, and then deed to the Exchangor.

Problem: Few non-Facilitator Company third parties have the time or expertise to handle this kind of transaction. There is also an additional excise tax imposed in this situation.

Sometimes, none of the alternatives presented above are feasible or acceptable to the Exchangor. Often, improvements cannot be completed within 180 days because of building permit lead time or the extent of the improvements required.

It may be possible to complete the improvements **after** the Replacement Property closing and still give the Exchangor credit for the cost of the improvements, but these improvements will **not** be a part of the exchange.

Refinancing the Relinquished Property **prior** to the sale of the Relinquished Property would place more of the equity of the Relinquished Property in the hands of the Exchangor outside of the exchange account. These refinancing proceeds could then be used to construct the improvements on the Replacement Property **after** closing of the Replacement Property. The funds would come from the Exchangor, rather than from the exchange funds. The value of the improvements will not count as part of the value of the exchange But, the Exchangor should get **basis** for the value of the improvements to the Replacement Property.

This refinancing approach would require that the Replacement Property value (before improvements) be high enough to match the Relinquished Property value. The refinancing of the Relinquished Property should be completed as early as possible before the sale of the Relinquished Property. If the Exchangor does not want to infuse even more cash in the transaction, the refinancing of the Relinquished Property will **raise** the amount of debt needed on the Replacement Property and will **lower** the amount of cash held in the exchange account.

Problem: The Exchangor may have to establish an independent business purpose for the refinancing of the Relinquished Property so that the IRS cannot argue that the borrowing was done to either:

A. Reduce the amount of cash to be reinvested in the Replacement Property; **or**

B. The refinancing was done just to circumvent the time deadlines for completion of the improvements.

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