



SPECIAL RULES FOR A “TO-BE-BUILT” EXCHANGE

Many real estate investors want to sell their current property and move up to a new investment property “to-be-built.” These investors can achieve this goal and defer significant capital gains if they closely follow the rules and time limits for an *IRC Section 1031, Like-Kind Exchange*.

In a like-kind exchange, you have 180 days after settlement of the property you are selling, the relinquished property, to take title to the replacement property. Thus, it is wise to get the builder started early on the construction of the improvements you desire on the replacement property. Regardless of the status of your relinquished property, you may write a contract at any time to purchase your replacement property with improvements “to-be-built.”

Once the builder has construction well under way and is within for certain 180 days of completion, the relinquished property can be transferred as part of an exchange. The contract with the builder on the new replacement property is then assigned to the qualified intermediary, and exchange escrow funds can be paid to the builder as additional deposits.

IDENTIFICATION. Special “to-be-built” rules apply whenever, between identification and receipt of the property, the property will be in whole or part constructed, built, installed, manufactured, developed or improved.

The 45-day identification of the replacement property requires a **legal description** of the property along with a **description of what is “to-be-built.”** That description should provide “as much detail regarding construction of the improvements as is practicable.”

RECEIPT OF “TO-BE-BUILT” PROPERTY. Special rules also apply for the receipt of the replacement property. The exchangor must receive **substantially the same** replacement property as identified before the end of the 180-day exchange period. If substantial changes are made in the property to be produced, the replacement property received may not be considered by the IRS to be substantially the same property as identified.

If construction of the replacement **real property** is not completed before settlement, it will be considered to be substantially the same property as identified only if, had production been completed, the property received would have been considered to be substantially the same property as identified. This rule applies only to real property.

Note: Some local jurisdictions will not permit the transfer of residential property from a builder to a new owner without the issuance of an occupancy permit. Exchangors should check local rules if construction will not be completed by the 180th day.

Real property completed after settlement is **not like-kind property**. Therefore, an adjustment must be made to reduce the exchange value of the replacement property by the value of the work not completed.

PROPERTY ALREADY OWNED. An important rule is that an improvement built on a lot already owned is not considered like-kind. Thus, if you already own the lot, you will have to sell it to the builder (a taxable event) or lease it to the builder for a period in excess of 30 years.

After the improvement is built, the lot and improvement are purchased from the builder or the leasehold interest and improvements are purchased. Before proceeding with one of these methods, the exchangor should seek legal and/or tax advice as the IRS has this area under review.

A previous alternate method was to have a third party Exchange Accommodation Titleholder (EAT) do a reverse exchange. The EAT would take title to the eventual replacement property lot and contract with the builder to complete the improvement. The procedures for this "safe harbor" process were established in *IRS Revenue Procedure 2000-37*. However, *IRS Revenue Procedure 2004-51*, effective July 19, 2004, modified the original procedure to restrict the EAT from taking title to any property owned by the taxpayer within the past 180 days.

Planning ahead, and involving your real estate agent, attorney, builder and qualified intermediary can result in achieving your goal of a new property along with significant tax savings.

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.

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