

# CHICAGO DEFERRED EXCHANGE COMPANY

## BUILD-TO-SUIT EXCHANGES

Since the Tax Reform Act of 1984 codified the 180-day exchange period under IRC Section 1031, real estate investors have wrestled with the provision that requires that any replacement property acquired in a like-kind exchange be received by the Taxpayer within 180 days from the date the old property is transferred.

This deadline is even more vexing to the Taxpayer who is trying to complete construction during the exchange period. Any number of factors can contribute to construction delays. Zoning variances, delayed building permits, financing, and inclement weather can create calendar chaos. And because the rules regarding construction are fairly stringent — any improvements made to the property after it is received by the Taxpayer are not considered “like-kind” to real estate — Taxpayers often find they are racing against the clock to complete a project.

There are several techniques a Taxpayer can consider using that maximize the value of the replacement property while minimizing the tax and business risk.

### **1. Third party seller constructs improvements and transfers improved property to Taxpayer.**

The seller agrees to undertake construction of improvements and then transfers the improved property to the Taxpayer within the exchange period. The upside: Taxpayer can use sale proceeds to make progress payments as the property is improved. The downside: It is unlikely you'll find a seller who is willing to undertake construction on property it's trying to sell. If you are lucky enough to find an accommodating seller, you still may not be able to secure your interest in the property during the exchange period.

### **2. Professional developer/builder acquires property from third party seller and constructs improvements.**

In this structure, legal title to the property is transferred to a professional developer who manages the construction within the exchange period. The upside: Taxpayer can use exchange proceeds to pay for the land to be transferred from the seller to the developer, as well as to fund the cost of the improvements. The construction process is managed by a professional, which should result in greater efficiency. Taxpayer may be able to secure its interest in the property by recording a mortgage against the property for the value of the land. The downside: Double transaction costs, fees to developer, and the Taxpayer may not have a security interest in the value of the improvements during the exchange period.

### **3. Qualified Intermediary acquires property from third party seller.**

Taxpayer manages construction process. Seller transfers the replacement property to a special purpose entity (“SPE”) owned by the Qualified Intermediary.

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The SPE acquires the property with exchange proceeds and enters into a construction management agreement with Taxpayer. Taxpayer then oversees the construction process either directly, or through a separate entity. The upside: Taxpayer has direct control over the project and may have a security interest in the property by appointment to the board of directors of the SPE that owns the property. The position allows the Taxpayer to block any voluntary bankruptcy proceedings brought by the SPE. Taxpayer has ready cash to fund the acquisition of the land and, often, some percentage of the improvements. The downside: Double transaction costs, additional fees to the Qualified Intermediary, and fees to the developer.

