

“Which Costs Count Toward The Exchange...?”

“What If I Don’t Meet My Equalization Target...?”

“What About My Particular Situation...?”

The Experts
have the answers to your questions...

¹⁰³¹ *What Is a* **Exchange?**

1031 exchanges are specifically structured transactions that join together the sale of an old property and the purchase of a new property for the purpose of deferring taxes.

Exchanges are primarily used for buying and selling investment real estate, but they can also be used for personal property that is used in a business. Examples of qualifying property include mineral interests, bare land, rental property, commercial buildings and homes other than your primary residence.

What Is a Construction Exchange?

A construction exchange allows you to sell your old property and use that money to buy a piece of bare land and build a building on it. There are a few critical things that you need to know:



You Must Equalize Your Exchange

The first critical rule is that you only have 180 days from the closing of your old property to equalize your exchange. The construction of the new building does not need to be completed by this time, but you need to equalize your exchange.

For example, you sell your old property for \$250,000 and you are thinking of buying a piece of land for \$100,000, and constructing a building for \$500,000 on it. The total project will run you about \$600,000. By the 180th day, you need to have at least \$250,000 invested in the new project (both land and construction) to equalize your exchange. And again, you do not need to have a Certificate of Occupancy by the 180th day.

The Costs Must Be “Installed Costs” to Count

For costs to be included in your construction totals and count towards your 1031 exchange, they must be “installed”. This means that you can not buy lumber, for example, and have it trucked to the site to count - it won’t count until you nail it together.

What Happens if You Don’t Meet Your Equalization Target?

If you don’t meet your equalization target (\$250,000 in our example), you pay tax on the amount that you fall short. Using our example, if you only incur \$200,000 of construction by the end of your 180 days, you would pay tax on the difference of \$50,000. As is true with 1031 exchanges in general, the gain comes first, which means that the entire \$50,000 is taxable - you get no offset for your investment in the old property.

*What Are the IRS Rules
for Exchanges...*



Once You Take Title to the Property, Your Exchange is Over

When you take title to the property, your exchange is over, at least on that property. For this reason, you need someone, other than your self, to take title to the land and do the construction.

One easy way to accomplish this is to have your builder buy the land. He will hold title to the property until you reach your equalization target, or until you run out of time on your 180 day limit. One problem that many

of our clients have with their builder taking title to the property is security. What happens if the builder goes bankrupt? What happens to the property? What if the builder is not performing? Can you get rid of the builder and still get your property back? What if there is a dispute over how much you owe the builder? Is there a way you can force him to transfer the property with out him holding it hostage?

For these reasons, most of our clients choose to have us take title

to the property. The title will be in the name of an limited liability company (an "LLC") that we will set up for just this purpose. The money for the purchase of the land and for payment of construction costs can come from your exchange account that we are holding. Of course, you still pick the architect, you pick the contractors, you pick the colors, you pick the carpet, etc., we just pay the bills. The LLC will continue to hold the land until you reach your equalization target, or until you run out of time on your 180 day limit.

"...What happens if the builder goes bankrupt? What happens to the property? What if the builder is not performing...?"



The IRS Rules for Exchanges...

You will need to follow six primary rules for your exchange to meet stringent IRS regulations:

- 1 Real Property Use.** Both your old and new properties must qualify as investment or business use. If both properties pass this test, you can exchange nearly any type of real estate.
- 2 45 Day Identification Period.** You have 45 days from the closing of your sale to list the properties you may want to buy. There are no exceptions to the deadline.
- 3 180 Day Exchange Period.** From the sale closing date, you have 180 days to close on the purchase of one or more properties from the 45-day list. Again, there are no exceptions to this deadline.
- 4 Qualified Intermediary (QI).** The IRS mandates that you use a QI to prepare the legal documents for your exchange. Because the QI must be independent, it cannot be your friend, employee, broker, or even your accountant or attorney. The QI also holds your money, so that you do not have access to it.
- 5 Proper title holding.** You must purchase and take title to your new property exactly as you held title to your old property.
- 6 Reinvestment Requirement.** To defer all of your capital gain tax, you must buy a property equal or higher in value than the one you sold. Also, you must reinvest all of the cash proceeds from your sale.

The regulations, court cases, and IRS rulings that apply to your exchange are ever-changing. It is important to choose a QI like **The 1031 Exchange Experts** that understands these laws, and carefully monitors new legal developments.

How Do You Identify the Construction on Your 45-Day Letter?



Since you will be taking title to the land and the partially completed building to complete your exchange, you need to identify this as such on your 45 Day Identification Form. In most cases your identification will read something like this: *“Purchase of the bare lot at 123 Main Street, Denver, CO, and the construction of a 10 unit apartment building, complete with landscaping and parking lot, thereon.”*

How Is The Construction Contract Handled?

If we are taking title to the property, the contract you negotiate with the builder should be in the name of the LLC that we set up to take title to the property. You should add a clause to this contract that allows you to assume the contract. In this way, the contract will stay in force even after the LLC transfers ownership of the property to you.

How Do The Construction Bills Get Paid?

As construction progresses, there will be a need for periodic payments. In most construction projects there is a general contractor. The general contractor typically gets paid once a month. He then pays the sub-contractors. The general contractors bill will detail how much of his bill is attributable to each sub-contractor.

The general contractor needs to submit his bill to you for your approval. After you approve it in writing, please fax it to our office for immediate payment. Funds for the payment of bill will be withdrawn from your exchange account and forwarded to the general contractor. These payments will include a “lien waiver” statement. We will not pay any bills until they have been approved by you first.

Can You Do Some of the Construction Work Your Self?

Yes, you may - but there is a problem with paying you for that work. One of the requirements for a proper exchange is that you may not touch the money in between the sale of your old property and the purchase of your new. Therefore, if you, Fred Jones, do the work, we can not write a check from the exchange account to Fred Jones for construction. On the other hand, if you own Jones Construction Company, we can write a check to the construction company for work it does.

What Happens if There Is a Construction Loan?

First of all, construction lenders rarely have a problem with construction exchanges, so it would be unusual for the lender to have a problem with us holding title to the land for the first few months of construction. Typically, you and the general contractor will prepare a “draw request” for the lender. This draw request usually shows the current state of construction and the costs incurred to date. Costs incurred through the last billing are also noted with the difference being the amount of the current draw request. The draw request is approved by you, and then sent to us (as long as we are still the owner of the property) for our approval. If you have already approved the draw request, we will sign it and immediately return it to the lender.

Usually the lender will pay the general contractor directly as soon as they get the signed draw request from us, and the lender will be responsible for attaching the appropriate lien waiver. In unusual cases the lender will forward the draw funds to us for disbursement.

What Makes an ExpertExchange Different?

What many QIs don't want you to know is that their industry is largely unregulated. Without standards, they can offer you little assurance of their training and qualifications. In fact, they will do little more in an exchange than fill in the blanks on generic forms.

But **The 1031 Exchange Experts** are different: we do *ExpertExchanges*. All of our exchanges are handled by a team of CPAs and real estate attorneys. Choosing our licensed professionals ensures that the education, knowledge and ethical standards of our team have passed rigorous testing.

You can trust our experience as well. We've completed thousands of qualified 1031 exchanges.

Don't just take our word for it. Our experts are published in trade journals across the country and cited in national publications like **Forbes** and **Bloomberg's Wealth Advisor**. So that's why we say *The 1031 Exchange Experts are writing the book on 1031 exchanges*.

Here's How a ExpertExchange Works:

- Our experts consult with you on how to best structure your exchange – always considering your particular situation.
- We meticulously document your exchange to meet all IRS requirements.
- We coordinate with your realtor, attorney, CPA and closing agent to properly complete the exchange.
- We keep everyone informed at critical points throughout the process with our exclusive *1031TouchPoints* program.

What Can I Expect with an ExpertExchange?

When you choose **The 1031 Exchange Experts**, you'll have reliable service before, during and even after your exchange. Our expert consultants are available seven days a week, virtually around the clock, to answer your questions as they arise.

How Can I Get Started?

All it takes is a phone call or e-mail, and **The 1031 Exchange Experts** will go to work for you. We are ready to provide further information and answer any of your questions.

Find Out More About Our Services:

Nationwide

Toll-free: 866-694-0204

Visit us at:

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