The Build-To-Suit Exchange

The build-to-suit exchange, also referred to as a construction or improvement exchange, gives the Exchanger the opportunity to use Exchange Funds for construction, renovations or new improvements, to the Replacement Property. In the most common type of build-to-suit exchange, the Exchanger sells the Relinquished Property through a Qualified Intermediary in a delayed exchange, and then acquires the Replacement Property after it has been improved using the Exchange Funds from the Relinquished Property sale. Note that any improvements made to the Replacement Property after the Exchanger takes title are not considered "like-kind". Treas. Reg. §1.1031(k)-1(e). To qualify for inclusion in the exchange, any improvements to the property must occur before the Exchanger takes title. *Bloomington Coca-Cola Bottling Company v. Commissioner,* 189 F.2d 14 (CA7 1951). Any unused Exchange Funds may be taxable as boot. Only funds disbursed for material actually in place and services actually performed will count toward the exchange value. Exchange Funds in an escrow "holdback" for post-closing improvements will not qualify even if the funds are deposited before the Exchanger takes title.

If the Exchanger wishes to include construction on the Replacement Property as part of the exchange, one option is to contract with the seller to have the construction completed before the transaction closes and the Exchanger takes title to the property. For a variety of reasons, this is often not a viable option. Rev. Proc. 2000-37 provides a "safe harbor" for structuring a build-to-suit exchange using an Exchange Accommodation Titleholder (EAT) to hold title to the Replacement Property pending completion of the improvements. Time limitations and all other rules of IRC §1031 apply to build-to-suit exchanges. The Identification Notice in a Build-To-Suit Exchange should include a description of the underlying real estate and as much detail regarding the improvements as is practical. To avoid boot, the Exchanger must ultimately acquire Replacement Property with a value equal to or greater than the value of the Relinquished Property, and use all of the exchange equity in the acquisition of the improved Replacement Property.

As in a typical delayed exchange, the build-to-suit exchange involves a Qualified Intermediary and begins when the Exchanger sells the Relinquished Property. Prior to closing on the purchase of the Replacement Property, the Exchanger enters into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT and assigns its rights in the purchase contract to the EAT. The EAT then acquires title to the Replacement Property. IPX1031 holds all parked properties in a separate special purpose holding entity (typically a single member LLC) for each exchange (the EAT and holding entity are jointly referred to as the EAT). The Exchanger or its designated representative is authorized by the EAT to act as its project manager to oversee all aspects of the construction. During the 180-day exchange period, the Exchanger, as project manager, sends construction invoices to the EAT for payment. The EAT must make payments directly to the vendors.

Build-to-suit exchanges are less complicated when the improvements can be paid for with cash loaned to the EAT by the Exchanger or with Exchange Funds advanced by the Qualified Intermediary. If a construction loan from an institutional lender is required, the Exchanger should seek lender approval prior to beginning the exchange, since the EAT, as titleholder to the Replacement Property, may be required to be the "borrower" on the loan. To protect the EAT from liability in the event of default by the Exchanger, the EAT will require the loan to be non-recourse as to itself. Lenders typically require the Exchanger to guarantee a loan made to the EAT.

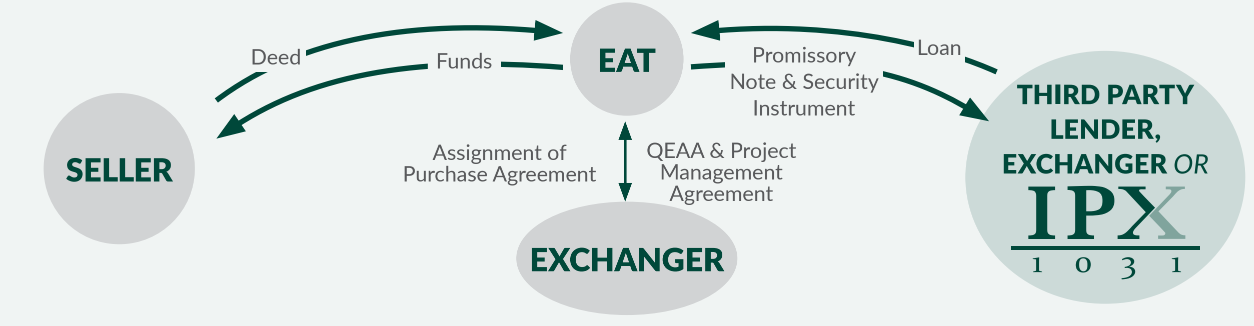
On the earlier of the end of the 180-day Exchange Period or completion of construction on the Replacement Property, the EAT will transfer the Replacement Property to the Exchanger to complete the exchange. Depending upon the Exchanger's preference, the Replacement Property is often transferred to the Exchanger by assignment of the sole membership interest in the holding entity rather than by a deed. Selecting the appropriate method for transfer of title should be determined after review of transfer tax and other legal issues by the Exchanger's tax and legal advisors. If a third party lender is involved, the Exchanger typically will assume the construction loan upon the conclusion of the exchange. Any construction to be included in the exchange must be completed and paid for prior to the holding entity's transfer of the Replacement Property to the Exchanger.

Rev. Proc. 2000-37 also permits the Exchanger to use an EAT to close on the purchase of the Replacement Property and commence construction of improvements, prior to the sale of the Relinquished Property. In reverse build-to-suit exchanges, since the Relinquished Property has not yet sold, the Exchanger or a third-party lender must loan funds to the holding entity to acquire and improve the Replacement Property.

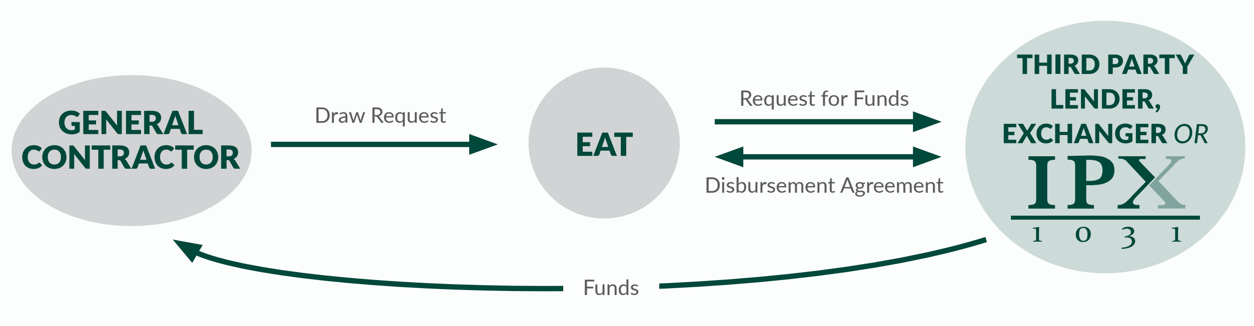
The Build-To-Suit Exchange (CONT.)

Phase I - Qualified Intermediary Facilitates Disposition of Relinquished Property

Phase II - Holding Entity (EAT under Rev. Proc. 2000-37) Acquires Title to Replacement Property



Phase III - Construction of Improvements



Phase IV - Qualified Intermediary Facilitates Transfer of Improved Replacement Property to Exchanger