Improvement Exchanges

"It is Important to Understand these Additional Requirements"

The improvement exchange is a powerful strategy that enables an investor to improve a replacement property. Although this provides tremendous flexibility and opens up a vast array of potential replacement property options, a couple of additional requirements must be followed to obtain full tax deferral.

IDENTIFICATION OF PROPERTY TO BE PRODUCED

The Regulations state the following regarding identifying a replacement property: "...a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time identification is made." This means the Exchanger should identify not only the property being improved but also specify the exact improvements to be made to this property. Often this is accomplished by identifying the parcel of land and providing a copy of the blueprints or construction drawings. The IRS does allow for running construction changes, such as relocating an interior wall by a couple of feet. Nevertheless, it is critical the property received by the Exchanger is substantially the same as the property identified.

RECEIPT OF PROPERTY TO BE PRODUCED

To qualify for a "safe harbor" improvement exchange (within the 180 day maximum exchange period) the Exchanger must actually receive like-kind real property, not services to be produced. Exchange proceeds that are not reflected in actual improvements to real property within the 180 day exchange period are considered boot since production services to be built in the future are not like-kind real property.

REPAIR VS. IMPROVEMENT

Some Exchangers want to know what fix up cost are considered a "repair" versus an "improvement" because a repair is deductible in the current tax year, whereas an improvement is amortized and depreciated over the life of the property.

The Department of the Treasury distinguishes between repairs and improvements in Reg. 1.162-4: "...cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinarily efficient operating condition, may be deducted as an expense...repairs in the nature of the replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall be capitalized and depreciated."

REPAIR: A repair keeps the property in good operating condition. It does not materially add to the value of the property or substantially prolong its life.

IMPROVEMENT: An improvement adds to the value of property, prolongs its useful life, or adapts to new uses.

The two key issues to examine are whether the property's useful life is appreciably prolonged or whether the value of the property has materially increased as a result of the expenditure. If neither of these conditions are present, and if the expenditure only restores the property or keeps it in an efficient operating condition, it is generally considered maintenance or a repair expense and should be deductible. The Tax Court has ruled that the proper test is to compare the value after the repair has been completed with the value prior to the existence of the condition necessitating the repairs, and not with the value immediately prior to making of the repair. See Plainfield Union Water Co. v. Commissioner, 39 TC 333 (1962).

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