

Practical Improvement Exchange Guide

Understanding the value and mechanics of an improvement, or build-to-suit exchange.



Why it matters: An improvement exchange can bridge a value gap when a lower-priced replacement property needs work. The property is parked with an Exchange Accommodation Titleholder (EAT) while improvements are made so qualifying completed work can increase the replacement property's exchange value.

WHAT COUNTS AS A CAPITAL IMPROVEMENT?

An **improvement exchange** (also called a construction or build-to-suit exchange) allows an investor to improve replacement property during the 1031 exchange period and potentially include the value of those completed improvements as part of the replacement property acquired in the exchange.

Key practical point: the work must become part of the real estate. Generally, a capital improvement is an addition or improvement to property that is capitalized rather than treated as an ordinary repair. IRS guidance describes improvements as including work that benefits the property, restores it, or adapts it to a new or different use. Improvements generally need to be completed and affixed/incorporated during the exchange period. Examples discussed include roofing, HVAC, flooring, electrical/plumbing work, an ADU, or new construction.

HOW THE MECHANICS WORK

	FORWARD IMPROVEMENT	REVERSE IMPROVEMENT
Sequence	Relinquished property sells first; replacement property is later acquired and parked with the EAT for improvements. <u>Then, the improved property is transferred to the investor.</u>	Replacement property closes first and is parked with the EAT; relinquished property is sold later, <u>and the exchange is completed (with improved property transferred to investor).</u>
Funding / Timing	Exchange proceeds can fund acquisition and improvements, but the 180-day clock starts when the relinquished property closes; a delayed replacement closing reduces construction time.	Investor/third-party financing typically funds acquisition and early improvements until the relinquished property sells. This can provide the full 180 days from acquisition <u>for construction</u> , but requires upfront funding.

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REQUIREMENTS & PRACTICAL WATCH-OUTS

- **Identify specifically.** Identify the real property and planned improvements by day 45. List what will actually be built, renovated, or installed; plans may be attached.
- **Count completed work.** Only improvements completed and affixed/incorporated into the real estate by the exchange deadline contribute to exchange value. Unfinished work may still be completed later, but may not count toward the exchange value.
- **Watch soft costs.** Architecture, engineering, permits, surveys, and environmental work may be paid during the exchange, but should lead to actual construction during the exchange period.
- **Plan for delays.** Permits, inspections, lenders, contractors, materials, and weather can consume a 180-day window quickly.
- **Coordinate early.** Bring in the QI/EAT, tax advisor, legal counsel, contractor, and lender before deadlines get close. A lease and construction-management agreement can give the investor practical control while the EAT holds title.
- **Document costs.** Keep invoices and records of out-of-pocket improvement costs, especially when the investor funds work directly.

Practical takeaway: The structure works best when the real estate deal and construction plan are ready for the same clock. Plan early, know the value gap, and focus on improvements that can take place during the appropriate window of time.

