"Soft Costs" in Improvement Exchanges

When constructing improvements, the first dollars out are most often spent on "soft" costs. Soft costs are expenses that do not relate to the direct construction of improvements. Some common examples of soft costs are architect and engineering fees, permits, surveys and environmental investigations.

While most tax advisors will agree that money spent on such items does increase the value of the property being improved and therefore increases the basis, it is an open question as to what treatment the funds spent on these items will receive in the course of a Section 1031 Tax Deferred Exchange. The main concern is the IRS may not consider plans and permits "like-kind" to real estate.

There are two main issues involving soft costs in an exchange. The first issue is one of constructive receipt and boot. If the soft cost improvements are not considered to be like-kind property, then the funds expended towards these types of improvements will be treated as boot and be potentially taxable. In addition, anytime exchange funds are spent on non-like-kind property in the course of an open exchange there is always a risk that the IRS will determine that the Exchanger had constructive receipt over the funds and, therefore, the entire exchange may be denied non-recognition treatment. Prior to the Holding Entity acquiring title to the parked property, the Exchanger should always check with his or her tax advisor as to the advisor's preferred method for handling soft costs in an exchange.

The second issue arises when the Exchanger does not want the Holding Entity to remain on title through completion of the project. Often the value of the land plus the amount of funds spent on soft costs will equal or exceed the value the Exchanger needs for a complete deferral of the gain from the sale of the Relinquished Property. To get a full deferral, the Exchanger must go even or up in equity and value from the Relinquished to Replacement Property. Ideally, the Exchanger would leave the Holding Entity on title until the value of the actual physical improvements met or exceeded the value needed for a complete deferral.

On occasion, the 180-day deadline may prevent completing a project to the point where there is enough value in the Replacement Property to qualify for full tax deferral. In that event, please contact your IPX1031 representative to discuss the feasibility of a non-safe harbor exchange.