Construction Exchanges Under Code Sec. 1031 Five Years After the Issuance of Rev. Proc. 2000-37

By Mary B. Foster

Mary Foster explores the current state of construction exchanges, examining how the provisions of the Safe Harbor can be fully utilized to minimize the taxpayer's cost and inconvenience in a construction exchange, looking at the rulings on the use of leasehold improvements as replacement property in a Safe Harbor construction exchange and reviewing the IRS's new position on construction exchanges outside the Safe Harbor.

Introduction

Over five years have elapsed since the IRS published Rev. Proc. 2000-37.[1] Rev. Proc. 2000-37 created a safe harbor (the "Safe Harbor") for "parking" exchanges under Code Sec. 1031, allowing taxpayers to "park" replacement property or relinquished property with a third-party "exchange accommodation titleholder" (EAT) for up to 180 days prior to the disposition of the relinquished property. The Safe Harbor also allows the EAT to construct improvements on the replacement property during the 180-day parking period, which will be referred to as a "construction exchange" in this article. Since the issuance of Rev. Proc. 2000-37, the volume of Safe Harbor "construction exchanges" appears to have increased significantly as taxpayers and their advisors have become more comfortable with the use of the Safe Harbor. The IRS has also issued favorable private letter rulings on the use of the Safe Harbor, liberally interpreting some of its provisions. On the negative side, the IRS issued Rev. Proc. 2004-51, modifying Rev. Proc. 2000-37 to prevent the use of the Safe Harbor by a taxpayer attempting to exchange into new construction on the taxpayer's own property. Furthermore, construction exchanges lasting beyond 180 days have become more difficult to structure, as the IRS has reversed its earlier position on the appropriate test for the validity of the parking arrangement outside the Safe Harbor.

This article explores the current state of construction exchanges. First, it examines how the provisions of the Safe Harbor can be fully utilized to minimize the taxpayer's cost and inconvenience in a construction exchange. Second, it looks at the rulings on the use of leasehold improvements as replacement property in a Safe Harbor construction exchange. Finally, the article reviews the IRS's new position on construction exchanges outside the Safe Harbor.

Use of the Safe Harbor for Construction Exchanges

Rev. Proc. 2000-37 created a Safe Harbor that allows the EAT to acquire replacement property in an exchange and construct improvements on the replacement property for up to 180 days. In the meantime, the taxpayer arranges for a sale of the

Mary B. Foster is currently President of 1031 Services, Inc. in Bellevue, Washington.

relinquished property to a third-party buyer. Rev. Proc. 2000-37 provides that the IRS will not challenge the treatment of an EAT as the beneficial owner of the replacement property if it is held in a "qualified exchange accommodation arrangement."[2]

Without the protection of the Safe Harbor, the taxpayer cannot be sure whether the EAT is considered the owner of replacement property for federal income tax purposes. Tax ownership is often uncertain and depends on who bears the benefits and burdens of ownership, or whether the legal owner is the agent of the other party.[3] (If the taxpayer is considered the owner of the property or if the property's title holder is considered the taxpayer's agent, the "replacement" property would be considered owned by the taxpayer prior to the exchange, and, therefore, such property would not qualify as replacement property.) The Safe Harbor removes this uncertainty. It also generously allows for non-arm's-length provisions in the qualified exchange accommodation arrangement between the EAT and the taxpayer. A taxpayer taking full advantage of the Safe Harbor with these non-arm's-length provisions will find only minor inconveniences from the exchange. Furthermore, the costs of structuring a Safe Harbor construction exchange are only the EAT fees and real estate transfer taxes in some jurisdictions.

Qualifications for the EAT; Maximizing the Use of the Safe Harbor

The Safe Harbor specifically defines who may be an EAT. The EAT cannot be the taxpayer or a "disqualified person," as defined in the regulations for deferred exchanges. A disqualified person is generally a related party to the taxpayer. An entity is a disqualified person if the taxpayer owns more than 10 percent of the entity. A person is also disqualified from acting as an EAT if the person has acted as the taxpayer's attorney, accountant, real estate agent or broker, employee or investment banker on nonexchange matters within the two-year period ending on the date the EAT acquires the parked property.[4]

The EAT must be a person subject to federal income tax. If the EAT is treated as a partnership or S corporation for federal income tax purposes, then more than 90 percent of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.[5] This requirement is easily met for most parking arrangements. However, a taxpayer attempting to do a Safe Harbor exchange in a foreign country will find that a foreign entity cannot be an EAT unless it is also subject to tax in the United States. This forces the taxpayer to use an EAT that is subject to U.S. taxation. Thus, the EAT, which is typically a U.S. corporation where a foreign transaction is involved, will need to comply with the tax laws and other laws of the foreign county, increasing the cost and complexity of the reverse exchange.

Rev. Proc. 2000-37 specifically states that if the taxpayer complies with the Safe Harbor requirements, then the EAT will be considered the owner of the replacement property for purposes of Code Sec. 1031.[6] The definition of a "disqualified person" depends entirely on the ownership tests (and being subject to federal tax) and not on the management of the EAT. Thus, the taxpayer can retain some control over the replacement property and the construction process by controlling the management of the EAT. The typical EAT is a sole purpose limited liability company (LLC), wholly owned by the qualified intermediary (QI) or an affiliated entity. The taxpayer can act as manager or other officer of this LLC. The taxpayer, as the manager of the EAT, can control the transfer of the replacement property to the taxpayer and can execute the deed, construction loan documents, construction contracts and other documents related to the replacement property or the improvements. The taxpayer can be registered agent and registered office of the EAT without violating the Safe Harbor. The taxpayer can also maintain a 10 percent or lesser ownership interest in an EAT in order to facilitate financing or management of the replacement property.

> Without the protection of the Safe Harbor, the taxpayer cannot be sure whether the EAT is considered the owner of replacement property for federal income tax purposes.

This may seem too good to be true because the cases and regulations under Code Sec. 1031 are so particular about constructive receipt issues with respect to the exchange funds. However, the IRS did acknowledge in a private letter ruling that the test of disqualified person is purely of ownership, and not control.[7] This ruling involved a QI in a deferred exchange. The rationale of the ruling also applies to an EAT in a Safe Harbor exchange, as the rules for disqualified persons are the same for both a QI and an EAT. The QI was not owned by a disqualified person, but manager of the QI was a disqualified person as to the taxpayer. As manager of the QI, this disqualified person had all management control and could only be removed after 300 days notice from owner of the QI. Because the maximum exchange period is only 180 days, the disqualified person could not be removed as manager of the QI during the entire exchange period. The ruling held that, even though the manager was a disqualified person under the regulations with respect to taxpayers, the disqualified person did not own an interest, directly or indirectly, in the QI. Thus, the IRS applied an ownership test, and not a management control test, for the determination of a disqualified person.

In another private letter ruling subsequent to the issuance of Rev. Proc. 2000-37,[8] the IRS ruled that the following language will not affect the Safe Harbor: "The EAT is acting solely as [customer's] agent for all purposes, except for federal income tax purposes." This language can be useful in avoiding transfer taxes in some jurisdictions. It also may assist the EAT in obtaining financing and permits for the replacement property. The taxpayer may also feel more comfortable that the EAT owns the replacement property only as the taxpayer's agent for non-tax purposes, and thus, the EAT cannot act outside the scope of its authority.

Qualified Indicia of Ownership:

The Safe Harbor also provides that the EAT must hold "qualified indicia of ownership" of the replacement property at all times from the date of acquisition of the replacement property until it is transferred to the taxpayer. Qualified indicia of ownership generally means legal title to the replacement property, or other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (*e.g.*, a contract for deed).[9]

Importantly, qualified indicia of ownership also includes interests in a disregarded entity, such as a single-member LLC, if the disregarded entity holds either legal title to the property or other indicia of ownership.[10] In a construction exchange, the replacement property will typically be held in a sole-purpose entity. The sole-purpose entity provides liability protection and is often required by the construction lender.

The EAT can be the sole purpose entity itself, transferring the replacement property by deed to the taxpayer at the completion of the exchange. Construction exchanges are more easily structured, however, with the EAT forming an LLC to hold legal title to the replacement property, and the EAT then transferring the LLC to the taxpayer as replacement property. This structure is preferred by the construction lender because the borrower does not change, as legal title stays with the LLC. It also can avoid additional title insurance premiums because legal title to the replacement property does not change. The IRS has issued several private letter rulings holding that the acquisition of 100 percent of an LLC constitutes the acquisition of the replacement property in an exchange.[11] If the taxpayer has been named as registered agent and registered office for the EAT, then the only document often necessary to complete the transfer of the replacement property to the taxpayer is a simple assignment of the membership interests of the LLC to the taxpayer.

Real estate transfer taxes should always be considered in structuring a Safe Harbor construction exchange because the EAT must transfer the replacement property to the taxpayer and pay the applicable transfer taxes on the transfer. Some states, such as Texas and Oregon, have no real estate transfer taxes. Other states, such as Florida and Maryland, have high transfer taxes that can add thousands of dollars to the cost of the exchange. Some states have exemptions from transfer taxes on transfers from agent to principal, and the EAT may make an express statement of agency for nonfederal tax matters, as discussed above. The exemptions should be researched and confirmed, however, before entering into the qualified exchange accommodation arrangement, or the taxpayer may have a costly surprise when the EAT transfers the replacement property to the taxpayer. For example, Pennsylvania, in need of tax revenue, has refused to accept the agency exemption for Safe Harbor exchanges.[12] A transfer of the membership interests in the LLC will avoid a real estate transfer tax in many states. Other states do, however, tax a transfer of controlling interests in an entity, so the taxpayer would need to rely on another exemption for the transfer of the LLC from the EAT, such as agency or no consideration.

The transfer of the interests in an LLC as replacement property can be problematic if the taxpayer is a married couple in a noncommunity property state. The IRS issued Rev. Proc. 2002-69, providing that a husband and wife owning an LLC as community property can be considered a disregarded entity for federal tax purposes, even though the LLC has two members.[13] Therefore, the EAT could transfer the LLC to the husband and wife as community property, and the LLC still would be considered the replacement property. However, an LLC that is not owned as community property is presumably considered to have two members and, therefore, a tax partnership. Thus, the married couple could not receive the LLC membership interest as replacement property. The EAT can form two LLCs to own the replacement property in 50-percent undivided interests, and then the EAT can assign 100 percent of one of the LLCs to each spouse as replacement property. Each spouse would then own 100percent of an LLC that owns an undivided 50-percent interest in the replacement property.

> Real estate transfer taxes should always be considered in structuring a Safe Harbor construction exchange because the EAT must transfer the replacement property to the taxpayer and pay the applicable transfer taxes on the transfer.

Structuring the Exchange

Improvements can be made to the replacement property : (1) in a deferred exchange, (2) in a reverse exchange or (3) started in a reverse exchange and completed after the relinquished property has been transferred in a deferred exchange. The construction does not need to be complete at the time of the EAT's transfer of the replacement property to the taxpayer, but only the amount of construction done up to the date of transfer to the taxpayer qualifies as replacement property. Improvements done after the taxpayer has acquired the replacement property do not qualify as replacement property.[14] The regulations provide that "any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind."[15]

> **Example.** EAT acquires land for $1 million and starts construction of a $4 million building. EAT engages taxpayer's construction company to build the building. Only $2 million of improvements have been made by the 180th day. The EAT transfers the land and $2 million of improvements to taxpayer on the 180th day, for a total of $3 million of replacement property. The taxpayer completes construction with nonexchange funds. If exchange funds are used for construction occurring after the property is transferred to taxpayer, those specific funds are taxable.

QI as EAT?

The person in title to the replacement property during the construction period can either be the QI acting as an EAT, or the EAT may be a separate taxpayer from the QI. Rev. Proc. 2000-37 provides:

> An exchange accommodation titleholder that satisfies the requirements of the qualified intermediary safe harbor set forth in section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under section 1031.[16]

The QI and EAT functions are conceptually easier to separate than to combine, as each plays a different role. Thus, they will be separate entities in most Safe Harbor exchanges. Regardless of who acts as the EAT, the following three phrases from Rev. Proc. 2000-37 must be included in the agreement to come within the Safe Harbor:

> (1)The EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under section 1031 and Rev. Proc. 2000-37; (2) the taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37; and (2) the EAT will be treated as the beneficial owner of the property for all federal income tax purposes.

Reverse/Deferred Improvement Example

This example will illustrate the issues and planning opportunities in a construction exchange. The exchange starts out as a reverse exchange, with the EAT acquiring the replacement property through a wholly owned LLC. The Safe Harbor allows a maximum 180-day period to complete the exchange, with the period commencing the day after the date of the EAT's acquisition of the replacement property. Thus, the taxpayer should be confident that the construction will be far enough along by the 180th day to meet a sufficient exchange value to defer adequate gain in the exchange. Construction permits and financing should be lined up by the time the EAT acquires title to the replacement property, or the taxpayer's plan may be frustrated by delays. The relinquished property will often sell during the construction period, and the exchange then becomes a deferred exchange. The taxpayer will want to use the exchange funds to pay for the improvements occurring after the sale of the relinquished property.

Example. The EAT acquires land for $1 million and will build a $4 million building on the land. Construction will take five-to-eight months. The taxpayer plans to sell the relinquished property valued at $4 million, with current debt of $2 million, thus yielding equity of $2 million. The closing date for the relinquished property is scheduled for the 60th day after the EAT acquires title to the replacement property. The EAT sets up a sole purpose LLC to acquire the replacement property. The EAT will assign the LLC to the taxpayer as replacement property in lieu of a deed.

Financing

The taxpayer will need to finance the EAT's acquisition of the replacement property and the start of the construction because the relinquished property has not yet sold, and no exchange funds are available. The financing can be either from the taxpayer, a party related to the taxpayer or a third-party lender.

The Safe Harbor provides that the following are permissible with respect to financing:

(1) The taxpayer or a disqualified person guarantees some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or indemnifies the EAT against costs and expenses; or

(2) The taxpayer or a disqualified person loans or advances funds to the EAT or guarantees a loan or advance to the EAT.

Third-Party Financing

If the taxpayer needs to obtain a construction loan on the replacement property from a third-party lender, then the construction loan may be made directly to the EAT with the taxpayer's guarantee. The membership interests in the EAT can then be assigned to the taxpayer at the end of the exchange as replacement property, with the construction loan intact and no assumption documents or additional mortgage taxes necessary. The taxpayer can also be appointed as manager of the EAT to handle and execute all loan documents. A construction lender should not have any problem with this arrangement because the lender has the replacement property as security for the loan, as well as the taxpayer's guarantee.

The third-party loan alternatively can be made to the taxpayer and then the funds can be lent by the taxpayer to the EAT. The third-party lender will usually want a security interest in the replacement property. The Safe Harbor does not specifically state that the EAT may subordinate the replacement property to a loan to the taxpayer. Thus, this is not the preferred structure for third-party financing. The Safe Harbor does allow the taxpayer to guarantee the obligations of the EAT, which are secured by the replacement property. Similarly, the Safe Harbor allows the taxpayer to loan funds to the EAT and to secure the loan against the replacement property. Therefore, the EAT's subordination of the replacement property to a taxpayer loan does not seem to be a departure from the Safe Harbor. However, if the Safe Harbor exchange is deferred exchange and exchange funds are used to acquire or improve the replacement property, then the replacement property should not be pledged for a loan to the taxpayer. This pledge might violate the constructive receipt rules of the deferred exchange regulations, which provide that the taxpayer cannot receive, pledge, borrow or otherwise obtain the benefits of the money held by the QI prior to the receipt of the replacement property or the end of the exchange period.[17]

Taxpayer Financing

The acquisition and construction of the replacement property can also be financed by the taxpayer though existing cash or an unsecured line of credit. This is the easiest form of financing for the taxpayer who has the means to do so. The EAT provides the taxpayer with a promissory note secured by the replacement property and/or a pledge of the membership interests in the LLC. Must this promissory note from the EAT to the taxpayer bear interest? The taxpayer will not want taxable interest income from the EAT, imputed or otherwise. There would be no offsetting deduction for the taxpayer against the interest income in a construction exchange. Rev. Proc. 2000-37 specifically allows for non-arm's-length provisions, including in the taxpayer loan:

> The property will not fail to be treated as being held in a [qualified exchange accommodation arrangement] as a result of [taxpayer loan to the EAT], regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements.[18]

The Safe Harbor does not require an interest-bearing loan. Will interest nevertheless be imputed under other provisions of the Code? The original issue discount rules of Code Sec. 1272 through 1274 have an exception for loans with a maturity date of not more than one year, and the loan from taxpayer to the EAT will be for a maximum period of 180 days.[19]

Code Sec. 7872 also imputes interest on below-market loans, and does not have an exception for loans of less than one year. Code Sec. 7872 applies to any below-market loan if the principal purpose of the interest arrangement is the avoidance of any federal tax. It also applies to other below-market loans, to the extent provided in regulations, if the interest arrangements have a significant effect on any federal tax liability of the lender or the borrower. Arguably, Code Sec. 7872 should not apply when a taxpayer loans funds to an EAT because the taxpayer is advancing funds to the EAT for purchase and improvement of the taxpayer's own replacement property. It is not disguised compensation to the EAT. The EAT is immediately applying the loaned funds to the taxpayer's replacement property, and not for the EAT's own benefit. Furthermore, the Safe Harbor blesses non-arm's-length provisions. Hopefully, the IRS would not assert the application of Code Sec. 7872 to non-arm's-length arrangements that it has otherwise approved under Rev. Proc. 2000-37.

Relinquished Property Financing

What if the taxpayer needs to borrow the funds for the replacement property acquisition with a loan secured by the relinquished property? What if a third-party lender will lend to the EAT on the replacement property, but the lender wants to lien the relinquished property as additional collateral? Does this constitute taxable boot to the taxpayer? The case law suggests that any borrowing secured by the relinquished property prior to the exchange should have independent economic substance, and the funds should not be borrowed in order to avoid tax on the exchange.[20] In this situation, the relinquished property debt is incurred to finance the acquisition and improvement of the replacement property in the exchange. The taxpayer is not cashing out on any of the equity in the relinquished property. The equity is being invested directly into the replacement property, albeit in the reverse order from a deferred exchange. Nevertheless, this remains an open issue in reverse exchanges.

Construction Issues

The Safe Harbor states that the following is permissible with respect to the actual construction of the improvements while the EAT owns the replacement property:

> The taxpayer or a disqualified person … supervises improvement of the property, acts as a contractor, or otherwise provides services to the EAT with respect to the property.[21]

The construction contract should be signed by the EAT, but the taxpayer can guarantee it. The taxpayer can also act as general contractor and contract with the subcontractors on behalf of the EAT. However, if the relinquished property has sold, and the EAT is using exchange proceeds to fund construction, the EAT should pay the sub-contractors and vendors directly, rather than pass exchange proceeds through the taxpayer's hands prior to receipt of the replacement property. This avoids any constructive receipt issues with respect to the exchange proceeds.[22]

The EAT must account for the ongoing construction costs and payments. The taxpayer or a related party, as construction manager, can keep track of all costs. The taxpayer can likewise approve all construction draws, and as manager of the EAT or construction manager, can even unilaterally authorize construction draws.

What Costs Are Calculated into the Value of the Replacement Property?

Soft costs, such as engineering and architectural fees, as well as permit fees, are often incurred by the taxpayer prior to the EAT's acquisition of the replacement property. Do these count towards the exchange value even though they were incurred prior to the start of the Safe Harbor arrangement? No authority addresses this issue. In a purchase transaction, these soft costs would be capitalized into the basis of the replacement property.[23] All construction costs incurred during the EAT's ownership of the replacement property are applied towards the exchange value of the replacement property, including property taxes and construction period interest. This is true even though the taxpayer or third party advances these costs on behalf of the EAT. The Safe Harbor does not appear to require the EAT to pass construction payments through its bank accounts.[24]

Use of Exchange Funds after the Relinquished Property Sale

In the example, the relinquished property is sold on the 60th day after the EAT has acquired the replacement property. The improvements have been underway during that period. The QI receives $2 million of exchange proceeds. Construction expenditures to date are $2 million, financed by the taxpayer. The replacement property cost thus totals $3 million, with $1 million of construction left to reach the relinquished property value of $4 million. Several issues arise at this point. The taxpayer will want to have the QI use the exchange funds to reimburse the taxpayer for the $2 million advanced previously to the EAT. Yet, the taxpayer has not received the replacement property, and will not do so for two or three months. May the taxpayer receive the exchange funds as a repayment of the taxpayer's loan to the EAT? Presumably, the QI would pay the exchange proceeds to the EAT, who would then pay them to the taxpayer as a repayment of the promissory note. Does this violate the constructive receipt rules contained in the deferred exchange regulations?[25] This is an open issue. Generally, cash received in an exchange by the taxpayer is offset by cash paid in the exchange by the taxpayer.[26] Applying this rule, the funds advanced by the taxpayer to the EAT offset the receipt of the exchange proceeds. There has been no ruling on this issue, however, so it should be avoided, if possible.

The taxpayer will also want the QI to use the exchange proceeds to fund ongoing construction. The exchange funds will be earning substantially less interest income in the QI's exchange account than the interest rate on the construction loan. Therefore, the QI should be instructed to pay down the construction loan, or to pay ongoing construction invoices with exchange funds. The QI does this as a loan to the EAT, or as a progress payment or earnest money deposit on the replacement property. The qualified exchange accommodation arrangement between the EAT and the taxpayer should be assigned by the taxpayer to the intermediary prior to any payments for the replacement property.[27]

Completion of the Exchange Example

The 180th day of the qualified exchange accommodation arrangement arrives. Due to delays beyond the taxpayer's control, construction costs, including the land, are only $3.8 million. The taxpayer is $200,000 short of the relinquished property exchange value and, thus, will be taxed on this trade down in value. The taxpayer wants to avoid recognition of any gain and thinks about prepaying the construction costs to expend the $200,000. Unfortunately, prepaid construction costs are not real property and, thus, are taxable boot in the exchange.[28] The taxpayer then wants to make up the $200,000 difference by paying a development fee or contractor fee to a related company to reach the exchange value. However, the taxpayer should consider that these fees are ordinary fee income, while taxable boot in an exchange is generally capital gain. Therefore, the taxpayer is generally better off tax-wise coming up short on the exchange value and recognizing the gain than making up any deficit with fees to the taxpayer or related entities.

To complete the exchange, the EAT transfers the replacement property to the taxpayer by an assignment of membership interests in the titleholder. Any remaining exchange proceeds are used by the QI to pay down the construction loan at the time of the transfer of the replacement property to the taxpayer.

Leasehold Construction Exchanges

Since the issuance of Rev. Proc. 2000-37, the IRS has issued two private letter rulings involving leasehold construction exchanges on land owned by a related party to the taxpayer. These rulings offer significant planning opportunities, with the caveat that they are only private letter rulings and thus cannot be relied upon. Further, the IRS ominously announced that it is continuing to study these types of transaction, as discussed below.[29]

The taxpayer cannot acquire the land, or improvements thereon, from a related party without potentially violating the related-party rules of Code Sec. 1031(f). The IRS also takes the position that a taxpayer cannot acquire improvements in an exchange on the taxpayer's own land using the Safe Harbor.[30] What about improvements on land held by a related party to the taxpayer? In these two rulings, the EAT acquired a ground leasehold on the land held by a related party to the taxpayer, and the EAT constructed the improvements on the leasehold. The EAT then conveyed the lessee's interest in the ground lease and improvements to the taxpayer as replacement property in the exchange. The improvements were thus, neither acquired from a related party, nor done on the taxpayer's own land. In each ruling, the ground lease was acquired from a related party, but had a fair market rental, and thus, no value. The only value was in the improvements. Both rulings did require that the neither the taxpayer nor the related party transfer its interest for at least two years following the transfer of the improvements to the taxpayer.

The EAT must account for the ongoing construction costs and payments. The taxpayer or a related party, as construction manager, can keep track of all costs

Reverse Exchange Ruling

In the earlier letter ruling, the related party had a lessee's interest in a 45-year ground lease from a governmental entity. The related party created a new sublease with the EAT as sublessee for 32 years.[31] Importantly, the sublease had a market rental to the EAT, although the ruling does not state how the rent was determined to be market. The taxpayer also entered into a construction loan with a bank and lent those funds to the EAT to fund the construction. The ruling does not state if the bank construction loan was secured by the leasehold. When the relinquished property sold, the QI paid the exchange funds to the EAT, who then used them to pay off the taxpayer's loan to the EAT. The taxpayer then paid off the construction loan.

Deferred Exchange Ruling

In the second letter ruling, the related party to the taxpayer assigned an existing ground lease to the EAT.[32] The exchange was a deferred exchange and the QI made monthly disbursements to the EAT from the exchange funds to make payments to the general contractor constructing the improvements. The taxpayer's parent corporation also received exchange proceeds from the QI as a reimbursement for third-party planning costs incurred prior to the exchange. This reimbursement suggests that such preplanning costs can be included in the exchange value, and the related party can be reimbursed prior to the end of the exchange period without invalidating the exchange, although the ruling contains no analysis of the constructive receipt issues of this reimbursement. The taxpayer purchased the leasehold improvements from the EAT at the end of the exchange period for a purchase price equal to the costs incurred by the EAT in constructing the improvements and acquiring the leasehold, including capitalized costs such as accrued real estate taxes, rent and the planning costs.

These rulings suggest the following: (1) the land or leasehold must be in the related party's name, not the in the name of the taxpayer or a disregarded entity owned by the taxpayer; (2) the leasehold should provide for market rent, with 30 years or more remaining on the lease term at the time it is transferred to the taxpayer as replacement property; (3) the lease should be left in place at least two years after the exchange and neither the taxpayer nor the related party should transfer its interest in the property during that two-year period; and (4) the leasehold can be newly created, as in the earlier ruling, or an existing leasehold, as in the later ruling.

Finally, these transactions should be structured with the following language from Rev. Proc. 2004-51 in mind:

> The Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate.[33]

Taxpayer Land

What if the land is held in the taxpayer's name? The preamble to Rev. Proc. 2004-51 provides the following:

> An exchange of real estate owned by a taxpayer for improvements on land owned by the same

taxpayer does not meet the requirements of Code Sec. 1031. *See DeCleene v. Commissioner*, 115 T.C. 457 (2000); *Bloomington Coca-Cola Bottling Co. v. Commissioner*, 189 F.2d 14 (7th Cir. 1951). Moreover, Rev. Rul. 67-255, 1967-2 C.B. 270, holds that a building constructed on land owned by a taxpayer is not of a like kind to involuntarily converted land of the same taxpayer. Rev. Proc. 2000-37 does not abrogate the statutory requirement of Code Sec. 1031 that the transaction be an exchange of like-kind properties.

Can this prohibition be remedied if the taxpayer transfers its land to a related party prior to the exchange? Rev. Proc. 2004-51 modified Rev. Proc. 2000-37 to provide that the Safe Harbor does not apply if the replacement property is owned by the taxpayer within the 180-day period prior to the EAT's acquisition of the replacement property. Thus, the taxpayer could transfer the replacement property land to the related party, wait 181 days and then commence the leasehold construction exchange with the EAT. The transfer of the land to the related party must not be a sham, and the related party must take over all the benefits and burdens of the ownership of the land. The taxpayer and related party should avoid the factors listed in the *Decleene* case, discussed below,[34] that are indicative of a failed transfer of benefits and burdens of ownership. Further, the transfer of the land by the taxpayer to the related party would have to reflect a fair market price, and thus, the taxpayer may possibly have taxable gain from the sale. Alternatively, the land could be contributed to a related partnership or corporation in a tax-free contribution to avoid the recognition of gain.[35] The step transaction doctrine could possibly be applied due to the pre-arranged nature of the transfer of the land to the related party and the later EAT arrangement. Creative taxpayers who like to plan ahead will acquire new properties in separate taxable entities to allow for the possibility of these leasehold construction exchanges. This would altogether avoid the issue of taxpayer-owned land addressed by Rev. Proc. 2004-51.

Reverse Exchanges Outside the Safe Harbor

Rev. Proc. 2000-37 provides a Safe Harbor only for reverse exchanges that meet its requirements. Some construction exchanges will fail to meet the 180-day limit. Rev. Proc. 2000-37 states that the IRS recognizes that parking arrangements can be accomplished outside of the Safe Harbor, and no inference is intended with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the Safe Harbor.[36]

Despite the favorable "no inference" language of Rev. Proc. 2000-37, the IRS has indicated in a Field Attorney Advice that it expects parking exchanges outside the Safe Harbor to be structured much differently than those within the Safe Harbor. Therefore, a taxpayer entering into a reverse constructions exchange must decide up-front whether to structure the transaction within the Safe Harbor, or to go to the time and expense of analyzing how to structure the exchange outside the Safe Harbor.

FAA 20050203F[37]

In this advice, the taxpayer attempted to effect a "reverse" exchange prior to Rev. Proc. 2000-37. A special purpose entity (SPE) acquired the replacement land and held title while the improvements were constructed. The taxpayer had a two-year, fixed-price option to purchase the replacement property from the SPE. The SPE borrowed all the funds from a bank, and the loan was guaranteed by the taxpayer. The IRS disallowed the exchange on the basis that the SPE did not hold the "benefits and burdens" of ownership of the replacement property during the parking period. The IRS stated that the following factors should be applied when determining whether the benefits and burdens of ownership have passed to the purchaser/SPE: (1) whether legal title passes to the purchaser; (2) whether the parties treat the transaction as a sale; (3) whether the purchaser acquires an equity interest in the property; (4) whether the sales contract creates an obligation on the part of the seller to execute and deliver a deed, and an obligation on the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays income and property taxes; (7) whether the purchaser bears the risk of economic loss or physical damage; and (8) whether the purchaser receives a profit from the operation, retention and sale of the property.[38]

The IRS then applied these factors to the transaction at hand and found that the SPE did not have sufficient benefits and burdens of ownership. This ruling represents a complete change from a prior private letter ruling approving a non-Safe Harbor reverse exchange, and illustrates the dangers of relying on private letter rulings obtained by other taxpayers. The IRS is not bound by its prior rulings, and personnel can change. The prior ruling did not use a benefits and burdens test, but stated that the appropriate test was agency. The exchange was valid if the accommodating party was not the taxpayer's agent.[39]

Structuring Non-Safe Harbor Exchanges

A future court decision will likely determine whether a non-Safe Harbor exchange is tested based on the accommodating party's benefits and burdens of ownership, or its lack of agency. At this point, exchanges outside the Safe Harbor should be structured with the IRS's new position in mind. This requires an analysis of whether the accommodating party has the benefits and burdens of ownership. There are several factors in the IRS's analysis that must be considered, as they go well beyond the simple Safe Harbor type arrangement.

Most significantly, the IRS expects the accommodating party to have an equity interest in the replacement property. Thus, the deal should not be 100-percent financed with no recourse to the accommodating party. The IRS has rejected this approach, even though such deals may otherwise be available on the commercial market if backed by a lease with a strong tenant. The IRS also does not state how much of an equity interest is sufficient. Estimates from private practitioners range from one to 10 percent of the total cost of the project.

A future court decision will likely determine whether a non-Safe Harbor exchange is tested based on the accommodating party's benefits and burdens of ownership, or its lack of agency.

Related to the equity investment, the IRS expects the accommodating party to have a risk of loss from the property, as well as a profit from the operation, ownership and sale of the property. This raises many questions with no ascertainable answers from the IRS. What does the IRS actually want to see with respect to the benefits of ownership? Must the accommodating party have any profit potential, other than a fixed fee? A developer in an arm's-length, build-to-suit deal will often base its profit on cost, plus a fixed mark-up. Must the purchase price to the taxpayer be based on the appraised fair market value at the time of the actual transfer to the taxpayer, even though the accommodation arrangement and the construction period have lasted two years? That seems commercially unreasonable. If the property is rented to the taxpayer during the parking period, the rent should be based on a fair market rate, which may require some type of appraisal. This may be costly for the taxpayer.

The IRS also appears to take issue with the taxpayer having possession of the property during the parking period through a lease, as well as the taxpayer paying the property taxes and insurance. This position ignores the entire world of triple net leases, which pass possession and operating costs through to the tenant as part of the rent.

Applicable Case Law

There are a few cases that provide conflicting authority between the agency analysis and the benefits-and-burdens analysis. In *F.L. Fredericks,*[40] the taxpayer's related construction company acquired the replacement property and constructed improvements. The court upheld the exchange on the basis that the construction company was not the taxpayer's agent. The construction company was an active business, and entered into financing arrangements and earned a significant fee for the construction. No benefits-and-burdens analysis was applied. This case was based on Code Sec. 1031 prior to the enactment of the related-party rules contained in Code Sec. 1031(f). Thus, a related party could not construct the improvements today without running the risk of violating these related party rules. However, an entity owned 50 percent by the taxpayer is not a related party under Code Sec. 1031(f). Therefore, an LLC or other entity owned 50 percent by the taxpayer could acquire the replacement property and construct the improvements in a construction exchange outside the Safe Harbor, even though such an entity would be a disqualified person in a Safe Harbor exchange. This LLC should bear the benefits and burdens of ownership due to the IRS's position, and should also take precautions not to be considered the taxpayer's agent.

In *DeCleene,*[41] the taxpayer already owned the replacement property and had obtained the building permit for the new building. He entered into an exchange agreement with the buyer of his relinquished property, and quitclaimed the land to the buyer. The buyer constructed improvements on the land and then transferred the land and improvements back to the taxpayer in exchange for the taxpayer's relinquished property. The court found that the taxpayer never divested himself of beneficial title to the replacement property land and thus, could not reacquire it in an exchange. The court reasoned that the buyer lacked economic risk for the land or the construction of the improvements. The buyer acquired the land with a nonrecourse, non-interest bearing note to the taxpayer, and the construction of the improvements was financed by a nonrecourse construction loan to the buyer, guaranteed by the taxpayer. The taxpayer had a contractual obligation from the taxpayer to reacquire the land and improvements at no profit or loss to the buyer. Further, the taxpayer paid all the real estate property taxes.

Conclusion

Since the issuance of Rev. Proc. 2000-37, construction exchanges within the Safe Harbor have become easier to accomplish, as several private letter rulings have taken a liberal interpretation of the Safe Harbor. The IRS also has issued private letter rulings stating that the Safe Harbor applies to leasehold improvements on a related party's land, but likewise has clarified that the Safe Harbor does not apply to improvements on the taxpayer's land. Finally, construction exchanges outside the Safe Harbor have become more perilous and expensive to structure due to the change in the IRS's position from an agency test to a benefits and burdens test.

Endnotes

1 Rev. Proc. 2000-37, 2000-2 CB 308.
2 *Id. at* §4.01.
3 *Id.* at §2.03; *J.H. Baird Publishing Co.*, 39 TC 608, Dec. 25,816 (1962).
4 Reg. §1.1031(k)-1(k); *Supra* note 1, at §3.03.
5 *Supra* note 1, at §4.02(1).
6 *Id.* at §4.02(1)(2).
7 LTR 200338001 (June 11, 2003).
8 LTR 200148042 (Aug. 29, 2001).
9 *Supra* note 1, at §4.02(1).
10 *Id.*
11 LTR 200251008 (Sept. 11, 2002), LTR 200329021 (Apr. 7, 2003), LTR 200118023 (Jan. 31, 2001).
12 PA Dept of Revenue, RTT-02-013.
13 Rev. Proc. 2002-69, 2002-2 CB 831. Community property states are AZ, CA, ID, LA, NV, NM, TX, WA and WI.
14 *Bloomington Coca Cola Bottling Co.*, 51-1 USTC ¶9320, 189 F2d 14.
15 Reg. § 1.1031(k)-1(e).
16 *Supra* note 1, at §4.03(1).
17 Reg. §1.1031(k)-1(g)(6).
18 *Supra* note 1, at §4.03.
19 Code Sec. 1272(a)(2).
20 *P. M. Garcia*, 80 TC 491, Dec. 39,937. (1983), *F. L. Fredericks,* 67 TCM 2005, Dec. 49,629(M), TC Memo. 1994-27.
21 *Supra* note 1, at § 4.03(5).
22 Reg. §1.1031(k)-1(g)(6). The taxpayer can only receive exchange proceeds at certain times.
23 Code Sec. 263(a)(1); Reg. §1.263(a)-2.
24 *See* LTR 200251008 (Sept. 11, 2002).
25 Reg. §1.1031(k)-1(g)(6).
26 Rev. Rul. 72-456, 1972-2 CB 468.
27 *See* LTR 200329021 (Apr. 7, 2003).
28 Reg. § 1.1031(k)-1(e).
29 Rev. Proc. 2004-51 §2.06.
30 *Id.* at §2.05.
31 *Supra* note 24.
32 *Supra* note 27.
33 *Supra* note 29.
34 *See Decleene*, 115 TC 457 (2000).
35 Code Sec. 721 or 351.
36 *Supra* note 1, at §3.02.
37 FAA 20050203F (Jan. 14, 2005).
38 The FAA cites *Grodt & McKay Realty, Inc.*, 77 TC 1221, at 1237-38, Dec. 38,472 (1981); a case involving a cattle tax shelter.
39 LTR 200111025 (Dec. 8, 2000).
40 *See* (*F. L. Fredericks*) *supra* note 20; *see also J.H. Baird Publishing Co., supra* note 3.
41 *See* (*D. Decleene*) *supra* note 34.