# Like-Kind Exchange Corner

## New Ruling Approves Newly Constructed Leasehold Improvements as Replacement Property in an Exchange when the Landlord is a Related Party

*By Mary B. Foster*

Taxpayers often want to acquire newly constructed improvements as replacement property in a Code Sec. 1031 exchange. This is commonly done using a parking arrangement under the safe-harbor provisions of Rev. Proc. 2000-37 (the "Safe Harbor") to acquire land from a third party and then to construct improvements on the land. However, in a recent private letter ruling, the land was owned by a related party rather than a third party, and the replacement property in the exchange was newly constructed improvements on a ground lease of the land.[1] This column briefly discusses construction exchanges under the Safe Harbor and then examines the new ruling, as well as prior rulings with similar structures.[2]



## Safe Harbor Construction Exchanges in General

The Safe Harbor allows an "exchange accommodation titleholder" (an "EAT") to acquire title to replacement property in a parking arrangement and hold it while improvements are made to the property. The improvements become part of the exchange value of the replacement property and thus can provide additional deferral of gain in an exchange. The maximum period of the parking arrangement is 180 days.[3]

For real property exchanges, the improvements do not need to be completed at the time of the EAT's transfer of the replacement property to the taxpayer. However, only the amount of real property improvements completed on the date of transfer to the taxpayer will qualify as replacement property in the exchange. Improvements done after the taxpayer has acquired the replacement property are construction services and do not qualify as replacement property.[4] 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."[5] For personal property exchanges, the production of the personal property must be completed before transfer to the taxpayer in the exchange.[6]

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Under the Safe Harbor, the taxpayer can supervise the construction of the improvements. The taxpayer can also fund the improvements or guarantee financing for the improvements. The EAT's only role is that of titleholder during the parking period.[7]

> **Example:** EAT acquires title to land for $1 million. EAT enters into a project management agreement with the taxpayer to construct a $4 million building. Only $3 million of improvements have been made by the 180th day of the parking period. On that 180th day, the EAT transfers the land and the $3 million of improvements to the taxpayer in an exchange, for a total of $4 million of replacement property. The taxpayer completes the $1 million of construction with nonexchange funds after the 180th day. If exchange funds are used for construction occurring after the property is transferred to taxpayer, those specific funds are taxable, even if the construction services are prepaid prior to the 180th day.

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The Safe Harbor is limited to 180 days, and thus cannot be used in major construction projects. But in many situations, a significant amount of construction can be done in 180 days, and taxable gain thus deferred. This is especially true if the project is shovel-ready when the EAT acquires the land.

Under the Safe Harbor, improvements can be made to the replacement property in any of the following structures: (i) a deferred (also known as a "forward" exchange); (ii) a reverse exchange; or (iii) started in a reverse exchange and completed in a forward exchange after the relinquished property has been transferred. In all three cases, the total parking period is limited to 180 days.

For many construction projects, the land must be purchased months or years before the construction can commence. If an EAT acquires the land in such a situation, the 180-day time limitation of the Safe Harbor would prevent most or perhaps all of the new improvements from qualifying as replacement property. If the taxpayer acquires the land in its name, the taxpayer will not be able to later exchange into improvements on the land, as discussed below. A related party to the taxpayer may instead acquire the land, but any improvements made directly by the related party cannot be acquired by the taxpayer as replacement property without likely violating the related party rules of Code Sec. 1031(f).[8] There is a solution to this timing problem, as discussed in the next section.

## Improvements Made by an EAT on Land Owned by Related Party

If the land must be purchased in advance of the commencement of construction of the improvements, a related party can acquire the land and hold it until the construction is ready to start. Then the related party can enter into a long-term leasehold with an EAT who can construct the improvements. The taxpayer can exchange out of a fee interest in the relinquished property into newly constructed leasehold improvements on the related party land as the replacement property. The leasehold must have a lease with a term of more than 30 years remaining when acquired by the taxpayer in the exchange to be like-kind to a fee interest.[9]

> **Example:** Assume the same facts as the prior example, but a related party has already purchased the land for $1 million. 180 days prior to the transfer of the relinquished property, the EAT enters into a 39-year ground lease with the related party as ground lessor. The EAT immediately starts construction of a $4 million building. After the sale of the relinquished property and on or before the 180th day following the commencement of the term of the ground lease, the ground leasehold and completed improvements are assigned to the taxpayer as replacement property in the exchange. The value of the replacement property is the $4 million building and does not include the value of the land.

This leasehold improvement structure was used in the 2014 private letter ruling. It was also previously approved in a 2002 private letter ruling[10] and a 2003 private letter ruling.[11] This structure works well to allow a taxpayer to match up the timing of the relinquished property disposition with the construction of the replacement property improvements so both can occur within the 180-day period of the Safe Harbor. For example, it may take longer than 180 days after the land acquisition to obtain the necessary entitlements to commence construction.

Therefore, a related party acquires the land rather than an EAT, and the taxpayer later uses the Safe Harbor to acquire leasehold improvements as replacement property in an exchange. Or perhaps the land must be purchased immediately, but the relinquished property sale date is more than 180 days in the future. Therefore, a related party acquires the land. The construction of the improvements is delayed until the date that is 180 days prior to the sale of the relinquished property. Then, on that date, the EAT enters into a ground lease with the related party and the taxpayer enters into a safe-harbor parking arrangement with an EAT for leasehold improvements.

Note that this structure also can be an effective estate tax planning tool. A taxpayer's heirs can purchase the land, an asset that appreciates over time. And the taxpayer can exchange into the leasehold improvements, an asset that depreciates over time and reverts to the heirs as landowners at the end of the lease term.

## The Parking Transaction "Study"

The two early private letter rulings were surprisingly taxpayer-favorable. However, soon thereafter in Rev. Proc. 2004-51, the IRS ominously announced:

> 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.[12]



This statement regarding the study had a chilling effect on these types of leasehold improvement structures. Advisors were wary of them, and only intrepid taxpayers would undertake them. Now, 10 years after announcing the study, the IRS has issued the 2014 ruling approving the leasehold improvement on related-party land structure. This implies that either the study came out favorably for the structure, or perhaps the study never happened. We do not know what actually happened. But with the issuance of the 2014 ruling, taxpayers and their advisors structuring these types of exchanges can clearly breathe easier.

## The Details of the Rulings

All three rulings have these facts in common: (1) the EAT acquired a leasehold interest in real property with a related party as the landlord; (2) the lease provided for fair market rent; (3) leasehold improvements were made by the EAT as the tenant during the period that the EAT held the leasehold; (4) the EAT conveyed the tenant's interest in the lease and ownership of the improvements to the taxpayer as replacement property in the exchange; and (5) representations were made that neither the taxpayer nor the related party would transfer its interest for at least two years following the transfer of the leasehold to the taxpayer.

This structure worked because the improvements were neither acquired from a related party nor done on the taxpayer's own land. While the leasehold interest was acquired by the EAT from a related party, the leasehold had a fair market rental and thus no value. The only value was in the leasehold improvements made by the EAT as tenant. Each ruling stated that the related party provisions of Code Sec. 1031(f)(4) did not apply because there was no cashing out by any of the related parties within two years of the last transfer in the series of transactions.

Each of the three rulings had slightly different facts. The 2002 ruling involved a reverse exchange. The related party had a lessee's interest in a 45-year ground lease from a governmental entity. The related party created a new 32-year sublease with the EAT as sublessee. The taxpayer entered into a construction loan with a bank and lent those funds to the EAT to fund the construction. When the relinquished property sold, the qualified intermediary ("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 from the bank.

The 2003 ruling involved a forward exchange. The related party assigned an existing ground lease to the EAT. The QI was holding exchange funds and made monthly disbursements to the EAT to make payments to the general contractor constructing the improvements. The exchange value of the leasehold improvements acquired from the EAT at the end of the exchange equaled 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.[13]

The 2014 ruling also involved a forward exchange, but with creation of a new sublease to the EAT with a related party as the sublessor/ground lessee. The fee owner appeared to be a related party too, but this was not explicitly stated in the facts. A vacant building on the premises was to be demolished, either by the related party ground lessee before entering into the sublease with the EAT or by the EAT after entering into the sublease. The sublease had a term in excess of 30 years, which the ruling stated was in excess of the useful life of the improvements.

Interestingly in the 2014 ruling, the taxpayer, or a related party, advanced the necessary funds to construct the improvements even though the QI presumably held exchange funds. The QI reimbursed the taxpayer for these construction advances, but such reimbursement was made at the end of the exchange. The taxpayer, a REIT, must have had readily available cash to fund the improvements. Most taxpayers would elect to use the exchange funds to make the improvements by having the QI make advances to the EAT, which was done in the 2003 ruling.

To recap, these rulings suggest the following: (1) the land or leasehold must be in the related party's name, not in the name of the taxpayer or a disregarded entity owned by the taxpayer; (2) the lease should have market rent; (3) the term of the lease should exceed the useful life of the improvements and in any case should have 30 years or more remaining on the lease term at the time it is transferred to the taxpayer as replacement property; (4) 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 (5) the leasehold can be newly created, as in the 2002 and 2014 rulings, or an assignment of an existing leasehold, as in the 2003 ruling.

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## What if the Taxpayer Already Owns the Land?

Many taxpayers are not good at planning ahead and acquire title to the land in their own name rather than a related party's name. The IRS takes the clear position that a taxpayer cannot acquire newly constructed improvements in an exchange on the taxpayer's own property using the Safe Harbor.[14] 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 problem be solved if the taxpayer transfers title to the 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 EAT's acquisition of the replacement property. The Safe Harbor thus contemplates that the replacement property could have been owned by the taxpayer at some prior period. Therefore, the taxpayer could potentially meet the Safe Harbor by transferring the replacement property land to a related party, waiting at least 181 days, and then commencing the Safe Harbor leasehold construction exchange with the EAT. It does not appear that the taxpayer in any of the three rulings had previously owned the land. The 2014 ruling explicitly stated that "Rev. Proc. 2004-51 has no bearing here because the replacement property held by the EAT has not been owned by the taxpayer."

If the taxpayer transfers land to a related party, the transfer must pass muster under general tax principles. Thus, it must not be a sham and should have a purpose other than tax avoidance. It is certainly desirable if the related party is an ongoing business and not an entity created only for this transaction. The related party should acquire all the benefits and burdens of the ownership of the land. The taxpayer and the related party should avoid the factors listed in the *D. DaCleene* case,[15] cited in the preamble to Rev. Proc. 2004-51, that are indicative of a failed transfer of benefits and burdens of ownership. Thus, if the related party purchases the property from the taxpayer, the purchase should be for fair market value and either be paid in cash or with a recourse, interest-bearing note. If third-party financing is used for the purchase of the property from the taxpayer, the related party, and not the taxpayer, should be responsible for the financing. The related party should also have possession of the property, pay the property taxes, insurance, *etc*.

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. To mitigate the step-transaction argument, the related party should not transfer the property back to the taxpayer immediately after the two-year period following the completion of the exchange, but the parties should plan on retaining the leasehold structure indefinitely.

The taxpayer may possibly have taxable gain from the sale of the land to the related party. In such a case, the land could be contributed to a related partnership or corporation in a tax-free contribution to avoid the recognition of gain.[16]

## Conclusion

The Safe Harbor provides an excellent tool to make improvements to replacement property. Although 180 days is not enough time for major construction projects, a surprising amount of construction can be done under the Safe Harbor if the project is shovel-ready and other factors, such as weather, do not delay construction. In addition, the leasehold improvement structure of the 2014 ruling provides a method to control the timing of the improvements to maximize the amount of improvements that can be done during the 180-day safe-harbor period. The ruling only applies to property held by a related party and not by the taxpayer itself. Savvy taxpayers will acquire new properties in separate taxable entities to allow for the possibility of these leasehold construction exchanges, thus avoiding the issue of taxpayer-owned land addressed by Rev. Proc. 2004-51.

### ENDNOTES

1 LTR 201408019 (Feb. 21, 2014).

2 The July–August 2007 edition of the Journal of Passthrough Entities contains an in-depth article on construction exchanges using the Safe Harbor. Mary B. Foster, *Related Parties and Code Sec. 1031(f): The Do's and Don'ts*, J. Passthrough Entities, July–August 2007, at 29.

3 Rev. Proc. 2000-37, 2000-2 CB 308 §4.01.

4 *Bloomington Coca-Cola Bottling Co.*, CA-7, 51-1 ustc ¶9320, 189 F2d 14.

5 Reg. §1.1031(k)-1(e)(4).

6 Reg. §1.1031(k)-1(e)(3)(ii).

7 *See* Mary B. Foster, *Construction Exchanges Under Code Sec. 1031 Five Years After the Issuance of Rev. Proc. 2000-37*, J. Passthrough Entities, March–April 2006, at 23.

8 *See supra* note 2.

9 Reg. §1.1031(a)-1(c), subsection 2.

10 LTR 200251008 (Dec. 20, 2002).

11 LTR 200329021 (Jul. 18, 2003).

12 Rev. Proc. 2004-51, 2004-2 CB 294 §2.06.

13 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 without invalidating the exchange, although the ruling contains no analysis of the constructive receipt issues of this reimbursement.

14 Rev. Proc. 2004-51, 2004-2 CB 294 §2.05.

15 *D. DaCleene*, 115 TC 457, Dec. 54,128 (2000).

16 Code Secs. 721 or 351.