

IRS Issues ANOTHER Ruling on Using Exchange Funds to Build on Property You Already Own

Recently I wrote an article analyzing a private letter ruling (PLR 200251008), released at the end of last year, that allowed a taxpayer to use exchange proceeds from the sale of one property to build improvements on a piece of land **that they already owned**.

This ruling came as a shock to the exchange industry because it completely departed from a major 1951 tax court case (*Bloomington Coca-Cola v. Commissioner*)



By Gary Gorman, CPA
and Managing Partner
of The 1031 Exchange
Experts

that disallowed such a scheme. Now, within a few months of the first ruling, the IRS has released a second ruling (PLR 200329021) that again allows a taxpayer to use exchange proceeds to build on their own land.

The IRS does not allow a taxpayer/exchanger to own (hold legal title to) both the Old and New exchange properties at the same time, under the simple principle that you cannot acquire new property if you already own it. Improvements to land (including newly constructed buildings) are part of the land that they sit upon as soon as they are constructed. This has always meant that you couldn't build on land that you already own, and count the new improvements as new exchange property. But with these two new rulings it appears that an entity separate from the exchanger may lease the land, construct improvements, and transfer the leasehold interest back to the exchanger.

1031
The Exchange
Experts LLC

present:

1031
NEWS

October, 2003

There are a number of reasons why this second ruling is highly significant: first, the issuance of a second ruling makes it clear that the first ruling was not a fluke, and that this really is the new IRS position on this issue. Second, with two rulings to compare, it is much easier to separate which factors in both rulings the IRS deemed critical to the exchange from the factors that were just peculiar to the first ruling.

The background in both cases is similar: the taxpayer sold property and did a 1031 exchange, using the funds from the exchange to build a structure on property it already owned. Analyzing both rulings side by side tells us the following:

Ownership of both the Old and New Properties –

In both rulings, the entity that owned the property that was sold was a slightly different legal entity than the owner of the land that was built upon. In both cases the entities were clearly related, but not exactly the same entity. This seems to be a coincidence rather than a requirement because the IRS does not comment on this in either ruling.

The land was leased – Rather than owning the land in fee simple interest, in both rulings the taxpayer was building improvements upon land that was held under a long-term lease. Again, this seems to be a coincidence rather than a requirement.

Transfer of Completed Property – in the first ruling, the Qualified Intermediary transferred **ownership of the titleholding entity** that it set up to construct the improvements. In the second ruling, however, the Intermediary transferred **the leasehold interest and the improvements** to the taxpayer. In the first ruling there were three LLCs that needed to be set up and involved in the structure. But this new ruling is good news because it makes the transfer of the constructed property easier; the exchanger does not have to fuss with taking title to an LLC, which can cause exchange problems if not done properly. It also allows intermediaries the flexibility to use either transfer technique without worrying about the transaction being disallowed.

Use of Exchange Proceeds to Pay for Construction – no problem here. Obtaining construction financing that is guaranteed by the taxpayer also does not seem to be a problem.

Time Frames – The fact that I find most difficult for exchangers is that in both rulings, construction was wrapped up within 180 days of the date of the closing of the sale of the taxpayer's Old Property.

Using these two rulings as guidance, I foresee these types of transactions, which are being called "build-to-suit" exchanges, will be structured like this:


Step 1 – the Intermediary sets up an LLC (called an Exchange Accommodation Titleholder, or "EAT" by the IRS) which leases the land from the taxpayer. This lease should have at least 30 years remaining life when construction is completed in order to qualify for the exchange. We are recommending that our clients use at least a 50-year life for this lease.

Step 2 – Construction is commenced on the property and paid for by the EAT. Payments can come from the client's exchange account or from a construction loan that may be guaranteed by the taxpayer. The client manages the construction (i.e., picks the contractors, the colors, the carpet, etc.), and oversees the contractors.

Step 3 – Upon the earlier of the 180-day deadline of the exchange, or completion of construction, the Intermediary transfers the leasehold interest and newly constructed improvements from the EAT to the taxpayer. The taxpayer now owns fee simple interest in the land in their name, along with a 50 year lease on the land, and the improvements.

Step 4 – Once the lease is owned by the taxpayer, we recommend that the lease remain in place until at least the expiration of the 3 year statute of limitations for the tax year in which the exchange took place. Once the statute of limitations has expired, most taxpayers will probably extinguish the lease and transfer or merge ownership of the property to a single ownership interest.

As a practical matter, all construction does not need to be completed, nor is a certificate of occupancy required – you merely need to equalize your exchange. But it bothers me that in both rulings construction was wrapped up in 180 days – most construction projects take a lot more than 180 days. "Reverse Construction Exchanges" where the intermediary takes title to the New Property and begins construction long before the sale of the Old Property (sometimes as much as two years before) are very common in this type of construction.

Revenue Ruling 2000-37, which sets forth the requirements for a reverse exchange, specifically contemplates such an extended time frame and yet these two new rulings seem very narrow. We'll just have to wait for further clarification on this. 

Gary Gorman, the founding partner of **The 1031 Exchange Experts, LLC**, has 30 years experience as a tax specialist in real estate. He has written and lectured extensively on exchanges, and is widely considered to be the one "Writing the Book on 1031 Exchanges."

The 1031 Exchange Experts is a firm of CPAs and Attorneys specializing in 1031s. They are one of the nation's fastest growing independent Qualified Intermediaries. Headquartered in Denver, Gary has offices in Stamford, CT and Naples and Miami, FL and Phoenix, AZ. Call toll-free 866-694-0204 for a free consultation, or visit their web site at www.expert1031.com.