nerej CELEBRATING 55 YEARS

Improvement exchanges: Increasing the value of a replacement property for an exchange

September 26, 2007 - Spotlights

In an exchange, the taxpayer must acquire replacement property of equal or greater value than the relinquished property to fully defer taxable gain. An improvement exchange (also known as a build-to-suit or construction exchange) is one way of increasing the value of replacement property for an exchange. Replacement property value is generated in an amount equal to the cost of improvements that can be invested into and become real estate while the property is parked with an exchange accommodation titleholder (EAT).

Improvement exchanges raise the following issues:

* Dealing with limitations caused by the forward exchange 180-day limit.
* Investing sufficient value in the replacement property during the limited time available.
* Documenting the amount of construction expenses.
* Establishing that construction expenses became part of the real estate.
* Using exchange proceeds to fund improvements to the replacement property.
* Identification of replacement property in the "forward exchange" portion of the exchange.
* Using land owned by the taxpayer or a related party as replacement property.

Time Limitations

The revenue procedure allows an EAT to hold property for up to 180 days. If the taxpayer starts a forward exchange, the period of time elapsed on the forward exchange will decrease the amount of time to park the replacement property. The time is shortened because the Code requires that the taxpayer acquire the replacement property within 180 days from the sale date of the relinquished property.

Sufficient Value

The 180-day limit makes getting enough value into the replacement property a challenge. Some properties, such as industrial properties, can be constructed in 180 days. Permitting and site work are time consuming and generate little increase in real estate value. If the taxpayer can arrange with the seller to perform permitting and site work before actually closing, the 180 days can be more efficiently used to build improvements.

Construction Expenses

In a reverse exchange, the EAT is considered the owner of the replacement property. The EAT borrows the acquisition cost of the land as well as the cost of improvements. The EAT must track these expenses for tax purposes as each construction advance is made. Often, forms like AIA Form G-702 are used to approve construction advances. The construction expenses must also be considered real estate in order to constitute replacement property in the exchange. For example, paying for materials delivered but not yet incorporated into a building will not generate real estate value. Taxpayer and EAT should review the construction disbursement documents and determine what expenditures constitute real estate.

Relinquished Property Funds

Taxpayer cannot receive, pledge, borrow, encumber, or otherwise receive the benefit of the exchange proceeds before the end of the exchange period. The use of exchange funds to satisfy the taxpayer's obligations on a pre-existing construction contract may be considered as giving the taxpayer the benefit of the exchange funds. A properly documented Improvement exchange addresses these issues by modifying the exchange agreement regarding use of the exchange funds and assigning the construction contract to the EAT. In two private letter rulings, PLR 200251008 and PLR 200329021, the service authorized the use of exchange proceeds to fund construction of property held by an LLC owned by the QI in a properly documented, integrated exchange transaction.

Identification

If the exchange is not completed during the 45-day identification period, the taxpayer must identify the replacement property in a forward exchange. The regulations require that the underlying land be particularly described, and that the improvements be described in as much detail as possible at the time of identification. One method of describing improvements is to refer to the construction plans and specifications. The improvements should be described as if describing the completed structure, irrespective of its stage of completion when taxpayer receives it as replacement property. The taxpayer must be careful that what the plans describe is "substantially the same" as what is actually built and acquired. Variation from the plans is acceptable, but major changes raise a potential identification issue.

Taxpayer or
Affiliate-Owned Land

This is a hot issue. In rev. proc. 2004-51, the IRS said that a transaction in which the taxpayer owned land, leased land to the EAT upon which EAT constructed improvements, and which the EAT transferred to the taxpayer as replacement property is outside the rev. proc. 2000-37 safe-harbor.

Constructing improvements on land owned by a taxpayer's affiliate and leased to the EAT was permitted in PLR 200329021 and PLR 200251008. The lease to the EAT must be appropriately structured and be at "fair market value" to avoid basis shifting between related parties.What happens with the ground lease once the exchange is completed remains an unresolved issue. Taxpayer cannot have a pre-arranged plan to cancel the lease, otherwise the step-transaction doctrine jeopardizes the exchange transaction. Arguably, termination of the lease after at least two taxable years should be relatively safe, since a two-year time period is permitted for direct related party exchanges under 1031(f)(1).

Safe harbor improvement transactions are among the more complicated reverse exchange transactions. Appropriately structured, these transactions offer an opportunity for significant tax savings. In particular, using exchange proceeds in appropriate situations may be significantly more attractive than obtaining a construction loan from a third party lender. In situations presenting complicated tax and legal issues, a sophisticated intermediary like Compass demonstrates its value through its ability to help you plan and complete transactions like improvement exchanges.

Andrew Gelson is a managing director of Compass Exchange Advisors LLC, Plymouth, Mass.