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Tax issues

Disappearing Lease Detour

Changes to IRS guidelines may require a new route for 1031 construction exchanges.

by Ronald L. Raitz, CCIM, CES

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During the last several years, many tax-deferred exchangers sold properties for a premium but found it challenging to locate and buy suitable replacement properties. Construction exchanges are a growing alternative because taxpayers can build value into the property to meet a specific price point. In the past, many taxpayers already owned the land on which they wanted to build improvements. These combined factors prompted tax advisers to devise suitable exchange alternatives incorporating these features. Among them was the “disappearing lease” exchange format.

However, last year the Internal Revenue Service issued Revenue Procedure 2004-51, which signaled its discomfort with this technique. This guidance specifically modifies Rev. Proc. 2000-37 to exclude safe-harbor treatment for improvements built on land a taxpayer has owned within 180 days of transferring the property to an accommodation titleholder.

Construction Exchanges Review

Taxpayers have been executing construction exchanges for years, and some methods have been more successful than others. But in 2000, the IRS issued Rev. Proc. 2000-37, which outlined how to structure reverse and construction exchange transactions using an AT to take title and “park” the targeted replacement property. In a typical construction exchange, the exchanger hires an AT to acquire the lot, make improvements on the lot, and sell it to the exchanger as replacement property. Because this guidance was issued in a safe-harbor format, the IRS cannot challenge the substantive matter of the transaction if it follows the outlined steps correctly.

However, there are several instances where tax courts have disallowed taxpayers building improvements on ground they already owned. Under this scenario, the taxpayer sells its property to another party; that party builds the improvements and subsequently sells the improved property to the taxpayer as the replacement property. Obviously, the taxpayer is using the value of the land it owned toward the exchange and, in essence, is buying back property it already owned.

The tax court disallowed this type of transaction in *DeCleene v. Commissioner*. In *Bloomington Coca-Cola Bottling Co. v. Commissioner*, the court agreed that the improvements being built did not constitute real estate but actually were prepaid construction services that were not like-kind.

The Disappearing Lease

To overcome these concerns, tax professionals redesigned the transaction by inserting a long-term ground lease, since the IRS considers a 30-year or longer leasehold interest to be like-kind with fee title. Thus, a land-owning exchanger hires an AT to enter into a 30-plus-year ground lease on the property. The AT, as tenant, causes the leasehold improvements to be built. Once the leasehold improvements reach the desired exchange value or the taxpayer is at the end of its 180-day exchange period, the AT transfers the leasehold interest and improvements to the taxpayer as its replacement property.

The taxpayer is not double dipping because it is not using the land's value for the replacement property: All of the value strictly is allocated to the improvements. In addition, the AT owns the leasehold improvements during the lease term, which legally don't become the fee-title owner's property.

When this type of transaction is completed, the taxpayer owns the fee title and is the lessee and lessor under the ground lease. Under most state laws, all of these interests merge to the highest form of ownership — the fee title. Hence the lease “disappears” into fee-title ownership.

Alternative Techniques

Rev. Proc. 2004-51 does not eliminate the disappearing lease, but it does put it into a non-safe-harbor category. Now the taxpayer simply falls under Rev. Proc. 2000-37's no inference paragraph found in Section 3, paragraph 2, “The service recognizes that ‘parking' transactions can be accomplished outside the safe harbor….” Non-safe-harbor reverse exchanges commonly are executed. Also, the IRS blessed an 18-month non-safe-harbor reverse exchange in Private Letter Ruling 2001-11025.

Rev. Proc. 2004-51 also states that the IRS will continue to study construction leasehold exchange transactions that use a related-party landowner. Recently, the IRS issued Private Letter Rulings 2002-51008 and 2003-29021, which approved two of these transactions.

With this new guidance, many tax professionals are altering their approach and using either a related-party element, an earlier transfer by the taxpayer, or both. To do so takes advance planning. For example, a taxpayer wants to build replacement property on ground that he already owns and wants to use the ground's value in his exchange calculation. He could transfer the property to a related party or sell to an independent third party that in turn sells the property to an AT 181 days later. The AT will cause the improvements to be built and then transfer the improved property (lot and improvements) to complete the exchange. This should work because the taxpayer would not have owned the property for 180 days prior to the AT buying it. However, the taxpayer will owe taxes on any gain associated with the lot's initial sale if it was sold to an independent third party.

In a different example, the taxpayer owns land on which it would like to build improvements as the replacement property. The taxpayer could transfer the lot to a related party that enters into a ground lease with an AT 181 days later. The AT then builds the leasehold improvements and transfers the leasehold improvements to the taxpayer as the replacement property. In many instances, the transfer of the property from the taxpayer to a related party is a non-taxable event and only the improvements' value has been used to determine the exchange calculation.

It seems clear that the IRS expressed its discomfort with the disappearing lease technique in Rev. Proc. 2004-51. But in typical fashion, as one door closes another one opens. With some pre-planning, taxpayers can use the value of previously owned land as part of their replacement acquisitions.