Tax Advisory

By Philip Sutton

New IRS Ruling Offers Guidance On 1031 Related-Party Exchanges

Taxpayers have long wanted to use their own capital expenditures as replacement property in 1031 exchanges. Recently, a client asked why he should be subject to a tax when he sold a building and used the proceeds to build a new building on land he already owned, and why the arrangement would not qualify for deferral as a 1031 exchange. A recently issued private-letter ruling provides taxpayers guidance on how to structure their transactions to achieve this intended tax deferral.

The ruling involves a number of steps needed to accomplish a 1031 exchange of property held by a taxpayer for improvements constructed by an exchange accommodation titleholder (EAT) on land already held by a party related to the taxpayer. It is critical to note that all of the transactions in the recent ruling were structured to come within a safe harbor for a reverse 1031 exchange under Revenue Procedure 2000-37.

The facts of the ruling are that a related party, which appears to have held unimproved land leased from a third party for some time, sublet the unimproved land to an EAT for a term of 32 years at market rates. The term of the lease was in excess of 30 years, so the EAT is treated as the fee owner of the land under Section 1031. The EAT then contracted with the related party such that the related party acts as construction manager for a project and hires and pays independent contractors to actually construct a building. Furthermore, the taxpayer arranged for construction financing from a third-party bank and from its own funds through a loan to the EAT. Once the improvements were constructed by the EAT, the taxpayer assigned a previously executed purchase and sale agreement for its relinquished property to a qualified intermediary (QI) and assigned its rights under the qualified exchange accommodation agreement to acquire the recently constructed property from the EAT. The EAT then transferred the interest in the property to the taxpayer, completing the exchange. As part of these transactions, the loan between the taxpayer and the EAT was repaid presumably by a transfer of proceeds from the QI to the EAT, thus enabling the EAT to repay the loan.

One of the ruling's unique aspects involves the use of land held by a related party at the time of the transaction; in the ruling the land was leased on a long-term basis by the related party. While exchanges among related parties are not prohibited, the IRS looks skeptically upon related-party exchanges that appear to be tax motivated. The ruling has a convoluted analysis of the related-party exchange rules of Section 1031(f) and seems to conclude that while the exchange did occur between related parties, there was no tax avoidance purpose.

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Here is a more straightforward example of the type of related-party exchange the IRS might seek to attack on the grounds of tax avoidance: Madeline controls two separate tax partnerships, each of which owns a single building. Building A has a value of $100 and a basis of $10. Building B also has a value of $100 and a basis of $95. Madeline would like to sell Building A for cash but still defer the gain. Madeline could swap Building A for Building B in a 1031 exchange, which would result in Building A taking on the $95 tax basis formerly attributable to Building B.

In this example, Building B takes on the $10 basis formerly attributable to Building A. Madeline would then sell Building A and only recognize $5 of gain, rather than the $90 she would have recognized had the pre-sale exchange not taken place. Presumably, if Madeline waited at least two years following the exchange, this basis swap might work. The IRS has the power to attack such transactions with a Section 1031 amendment enacted in 1989.

What if Madeline wanted to sell Building A instead and use the proceeds to build a new asset on land she already owned? Why should the related-party exchange be any different than if Madeline first constructed a building and then exchanged it for an old building she already intended to sell? Generally, this sort of transaction is structured by first transferring the land to a related party and having the related party enter into a long-term ground lease with the EAT. If Madeline had instead directly leased the land to the EAT, there would be concern that the lease would be ignored because she would be obligated to acquire the improvements subject to the lease as part of the arrangement with the EAT, and she would be treated as if she were acquiring improvements made on her own land, which the IRS says does not qualify for 1031 exchange treatment. ■

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