New York Law Journal
Volume 230

Monday, August 18, 2003

News

IRS FAVORS NEW § 1031 TAX-DEFERRAL AVENUE

Recent Rulings Provide Guidance for Improvement Exchanges on Exchanger-Owned Land

Todd R. **Pajonas**

HISTORICALLY, Americans have never had a great affection for being taxed. The great author and political commentator Mark Twain, once stated that the difference between a tax collector and a taxidermist is that a taxidermist only takes your skin. Thus, it usually sparks great interest whenever the Internal Revenue Service may appear willing to allow a new avenue to avoid paying capital gain taxes.

Recently, the IRS issued two Private Letter Rulings that permitted "exchangers" to complete an IRC § 1031 tax-deferred exchange where the replacement property consisted of improvements made to real property that the taxpayer or an affiliate owned prior to starting the exchange. These rulings provide useful guidance to tax and legal advisors, as they are a clear departure from previous rulings wherein the IRS disallowed these structures.

Before discussing these new rulings, however, some background is in order on § 1031 exchanges in general, so-called "parking arrangements," and the concept of "related parties.'

A properly structured tax-deferred exchange under § 1031 of the Internal Revenue Code of 1986, as amended (IRC), allows an owner of real property, the "exchanger," to defer the recognition of capital gain taxes normally recognized upon the sale of real property. In order to complete a fully tax-deferred exchange, an exchanger must:

- acquire a property that is equal or greater in value to that of the relinquished property;
- reinvest all of the net proceeds from the sale of the relinquished property in the replacement property;
- obtain financing on the replacement property that is equal to or greater than the financing that was paid off on the relinquished property; and
- receive nothing except "like-kind" property.

A valid partially deferred exchange can be structured even if an exchanger does not fully comply with one of these rules, such as purchasing a replacement property for $100,000 less than the relinquished property was sold for, as the exchanger will only be taxed on the difference.

Since the value of the replacement property is the acquisition price, an exchanger wishing to include the value of improvements made to the replacement property in its total value (paid with exchange funds) must structure the exchange as a "parking arrangement," discussed below. A parking arrangement in this situation allows an exchanger to have a separate entity acquire the replacement property, and to then have real property improvements made to that property using exchange funds.

The exchanger obtains a greater level of deferral since the replacement property has now been improved. Again, though, even if the improved replacement property

falls short of being equal to or greater in value to the relinquished property, the exchanger can still obtain the benefit of a partial tax-deferred exchange for the value of the replacement property at the time it is transferred in completion of the exchange.

In order to qualify for exchange treatment, both the relinquished and replacement properties must be of "like-kind." Like-kind property is defined as property held for productive use in a trade or business, or for investment purposes, that is exchanged for property that is also held for productive use in a trade or business, or for investment purposes. IRC § 1031 (a)(1). Like- kind refers to the nature or character of the property, and "[t]he fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class." Treas. Reg. § 1.1031 (a) 1(b). Any property conforming to this definition will be considered like-kind.

Parking Arrangements

While most exchanges are structured as "forward" or "delayed" exchanges, where the relinquished property is sold and the replacement property is then acquired within 180 calendar days, parking arrangements are structured much differently. A parking arrangement is necessary (a) when an exchanger wishes to acquire the replacement property before selling the relinquished property, (b) the exchanger needs to make improvements on the replacement property before taking title to it; or (c) a combination of these two exchanges, where the exchanger acquires and improves the replacement property prior to selling the relinquished property. These are the reverse, improvement, and reverse- improvement exchanges, respectively.

Whereas in a delayed exchange, title to the relinquished and replacement properties passes between the exchanger and the buyer and seller, respectively, in a parking arrangement, an entity known as an Exchange Accommodation Titleholder (EAT) takes title to the "parked property." The need for the EAT to hold title to either the relinquished or replacement property is driven by the fact that an exchanger may not own both the relinquished and replacement properties at the same time. Thus, one of the properties must be "parked.'

It is only within the last few years that there has been reliable guidance on the structure of a parking arrangement. On Sept. 15, 2000, the IRS released Rev. Proc. 2000-37, which provided a safe harbor for structuring parking arrangements. In order to fall within the safe harbor provisions the exchanger must, among other things, have an EAT hold title to the parked property; identify the relinquished property within 45 days of the acquisition of the replacement property by the EAT; and complete the exchange within 180 days.

The IRS also stated that a parking arrangement did not necessarily have to comply with Rev. Proc. 2000-37 in order to be valid. A parking arrangement structured as a "non-safe harbor" parking arrangement allows a taxpayer to go beyond the 180-day date necessary to complete a safe harbor exchange. Although this can provide some exchangers with much-needed flexibility, it also comes at the price of being considerably more risky, since there is little guidance from the IRS in this area. Accordingly, most parking arrangement exchanges are structured as safe harbor exchanges.

Improvement Exchanges

In a "normal" improvement exchange, an exchanger disposes of the relinquished property; the EAT purchases replacement property from a third- party seller utilizing a portion of the exchange funds; and thereafter, the EAT uses the remaining exchange funds to improve the property. The exchanger gets the dual benefit of having the replacement property improved to its specifications while obtaining a greater tax deferral than if it had acquired the replacement property at

a lower value and performed construction after taking title.

In the past, the IRS issued rulings that were not in favor of taxpayers making improvements to property they already owned, sometimes due to the "related party" rules (see below). The IRS has not, and still does not, look favorably upon acquisitions of replacement property from a related party. See Private Letter Ruling 9748006, wherein the IRS disallowed a tax deferral to an exchanger who purchased his mother's property. The agency's chief concern appears to stem from the facts that it looks at the exchanger and the related party as a single economic unit, that exchange funds will be paid from a related party to acquire the replacement property, and that thereafter the related party has the potential to return the money to the exchanger. Although the exchanger is now on title, the transaction allows the related party the continued benefit of the property, through the related exchanger, while having received the money in what amounts to a tax-free exchange.

A "related party" is any person bearing a relationship to the exchanger as defined in IRC § 267(b) or § 707(b). Some examples of related parties are family members, two corporations of the same control group, or a corporation or partnership in which the exchanger owns a 50 percent or more interest. Accordingly, the ultimate related party is the exchanger itself. So, for example, if the exchanger owned a 50 percent or more interest in an entity that owned the replacement property, the IRS would consider it a related party transaction, and possible disallow it. In addition, the exchanger's federal tax return for the tax year in which the exchange was completed must include Form 8824, which asks the exchanger if there were any related parties to the exchange.

The New Rulings

On Sept. 11, 2002, and April 7, 2003, the IRS released Private Letter Rulings 2003329021 and 200251008, respectively which, although not identical, set forth the following general structure for an improvement exchange on exchanger-owned land:

1. The exchanger will enter into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT, and will enter into an exchange agreement with a Qualified Intermediary (QI).

2. The exchanger will lease the replacement property to Titleholder, a disregarded entity wholly owned by EAT, at a fair market rental, for 32 years, as part of a QEAA as defined in Rev. Proc. 2000-37.

3. Exchanger (or a third-party bank where the exchanger gives its personal guaranty) will lend Titleholder the funds necessary to construct the improvements on the leased property.

4. Exchanger will assign its rights to the sale agreement to the relinquished property to the QI.

5. Exchanger will transfer title to the relinquished property through the QI, and the QI will receive the sale proceeds.

6. Exchanger will assign its position in the QEAA to the QI.

7. QI will use proceeds from the sale of the relinquished property to pay EAT for its interest in Titleholder (which holds all of the replacement property, consisting of leased property and newly constructed improvements to suit the exchanger's requirements).

8. EAT will use the proceeds received from QI to pay Construction Manager and to pay the construction loan in full; QI will direct EAT to transfer its interest in Titleholder directly to exchanger.

One of the key elements to this structure is the long-term lease of the replacement

property to the Titleholder. Treas. Reg. § 1.1031(a)-1(c)(2) provides that a fee interest in land is of like-kind to a leasehold of land if said leasehold has a remaining term of 30 years or more, including renewal options as yet unexercised. Accordingly, when the Titleholder leases the land for this period of time, and thereafter adds value to the property through these tenant improvements, the subsequent transfer of the interest in the Titleholder to the exchanger as replacement property, which now includes the value of the improvements, causes the exchanger to receive like-kind property in compliance with IRC § 1031 (a)(1).

Structuring a real estate transaction as a parking arrangement, however, of which an improvement exchange is one example, creates certain land title issues that should be addressed by a title insurance company. Additionally, a parking arrangement starts out with an acquisition of either the relinquished or replacement property by the EAT, which later transfers title to the property, or the ownership interest in the EAT entity, to the exchanger in completion of the exchange. Accordingly, a determination as to any transfer tax due upon the disposition of the parked property by the EAT to the exchanger, and whether title insurance coverage is obtained during the EAT's period of ownership, needs to be made.

Title Insurance Considerations

Although the EAT is generally the subsidiary of a Qualified Intermediary, no title insurance benefits will be available for the parked property unless a title insurance policy is purchased with the EAT as the named insured. This situation creates a possible burden on the exchanger to purchase two separate title insurance policies: one for the EAT during its period of ownership, and an additional title policy when the exchanger takes title from the EAT.

The rate manual issued by the Title Insurance Rate Services Association, Inc. (TIRSA) controls, by the authority and approval of the Superintendent of Insurance of the State of New York, the premiums charged and the continuation of coverage of a policy upon certain events (among other things). Unfortunately, for a direct transfer of title from the EAT to the exchanger there are no exceptions contained within Section 32 - Continuation of Coverage of the TIRSA rate manual, nor are there currently any endorsements available that would allow the title insurance coverage to continue onto the exchanger after the disposition by the EAT.

There are, however, several ways to provide a title insurance solution for the exchangers who are concerned with this issue. Firstly, if the property to be parked is the relinquished property, which means that the exchanger is transferring title to the property it currently owns to the EAT, a full covenant and warranty deed can be used to continue most of the benefits of title coverage to the EAT entity during its period of ownership. Since the exchanger has presumably been on title for an appreciable period of time, it is reasonable to believe that any potential title insurance issues might have been discovered already. Thus, the period of ownership by the EAT without the direct benefits of a title insurance policy may be within the reasonable risk tolerance of most exchangers. However, the unfortunate reality is that most exchanges are structured as the replacement parked variant due to certain financing and structuring issues.

Conversely, as an EAT is usually a special purpose entity formed for the sole purpose of holding title to the property during the period of the exchange, and normally dissolved immediately thereafter, there is not as much benefit to the EAT transferring title with a full covenant and warranty deed to the exchanger. The difficulty of commencing an action against a dissolved entity, and potential statute of limitation issues, make this an imperfect solution.

A structure that provides for title insurance coverage during the EAT's period of ownership, as well as a continuation of that coverage once the exchange is complete, involves transferring ownership of the EAT entity to the exchanger, instead of title to the real property.

Normally, in order to have a valid exchange, the exchanger must dispose of and acquire only real property in order to have a valid exchange. IRC § 1031(a)(1). In addition, the entity that disposes of the relinquished property must be the same entity that takes title to the replacement property. However, a limited liability company with only one owner will be classified either as a disregarded entity or a corporation, whereas an entity with two or more members will be classified as a partnership or a corporation. Accordingly, an entity with only one member that does not elect to be treated as a corporation will be treated as a disregarded entity. This allows an exchanger to take title to the replacement property by purchasing the interest of the EAT, as long as the exchanger treats it as a pass-through entity, without jeopardizing the viability of the exchange. Treas. Reg. § 301.7701-2(c). By purchasing the interest of the EAT, the title insurance coverage continues without the need of a second policy.

Comparing an exchange scenario to that of an IDA leaseback scenario could provide a more definite and less cumbersome solution to this problem. Currently there is available for entities taking advantage of Industrial Development Authority (IDA) financing and endorsements to the title issuance policy. When an entity purchases a property in conjunction with the IDA, it is the IDA that acquires the property on behalf of the entity, with construction and/or improvements being financed by the IDA. Typically, the property is then "triple net" leased to the entity for approximately 20-30 years, after which time the property is acquired by the entity for nominal consideration. And although the IDA entity has legal title to the real property, the court in Davidson Pipe Supply Co. v. Wyoming County Industrial Development Agency, 85 N.Y.2d 281, 624 N.Y.S.2d 92 (1995) cited the following:

The conveyance of legal title to the agency with simultaneous lease back to the company is structured merely as a mechanism to facilitate financing and is not a genuine allocation of ownership in the agency. The economic benefits and burdens of ownership are reserved to the company and the agency serves only as a conduit for the tax benefits provided by such an arrangement ....

Accordingly, an IDA endorsement to a title insurance policy provides a continuation of the benefits of the title insurance policy to the beneficiary of the financing after the IDA entity transfers title to the property upon completion of the IDA financing term.

In a completely analogous situation, an EAT takes legal title to a property in order to effectuate a parking arrangement tax-deferred exchange pursuant to IRC § 1031, and in the case of a safe harbor parking arrangement, Rev. Proc. 2000-37. However, although the EAT has legal title to the property, it is, in effect, being held for the benefit of the exchanger, and title to the replacement property will vest in the exchanger upon completion of the exchange. Since a parking arrangement and IDA financing are structured in much the same way, it makes sense to assume that an endorsement providing for a continuation of the title policy once title is vested in the exchanger for parking arrangements would be permitted. Unfortunaly there is not an endorsement of this nature for § 1031 exchanges.

Transfer Tax Considerations

The State of New York imposes a transfer tax on a conveyance of real property where the consideration exceeds $500. N.Y. Tax Law § 1402. In addition, there can be additional transfer taxes due in various areas, such as New York City and the Peconic Bay. The question is whether a transfer tax is due when the EAT transfers title to the exchanger in completion of the exchange.

When a replacement property is parked with an EAT, a transfer tax is levied upon that purchase. It is the transfer tax that would normally be due with the subsequent transfer of the parked property to the exchanger that is in issue.

N. Y. Tax Law § 1405(6) exempts from payment of the real estate transfer tax

[c]onveyances to effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership, other than conveyances to a cooperative housing corporation of the real property comprising the cooperative dwelling or dwellings ...

Although the EAT must have qualified indicia of title to satisfy the provisions stated in section 4.02(1) of Rev. Proc. 2000-37, the EAT is holding the property for the benefit of the exchanger to complete an IRC § 1031 tax deferred exchange. The Peconic Bay transfer tax, which is levied upon buyers of real property, contains the same exception. Accordingly, exchangers should feel comfortable invoking this section of the tax law to avoid paying a duplicate transfer tax.

In addition, a "conduit" exception was found under similar circumstances for exchangers wishing to park property located in the City of New York. In the Matter of 46 West 55th Street Corp., New York City Tax Appeals Tribunal, Decision no. 92-0408, June 3, 1999. Although a portion of the ruling had to do with agency issues that were cleared by the amendments to IRC § 1031 in 1986, "the tribunal stated that its duty is to apply the transfer tax based on the record before it and to determine the 'true nature of the transaction' as derived from the record, rather than to attempt to protect 'the interests of all of the many taxing authorities' by insisting that a characterization adopted for one tax be a determination for all taxes." Ronald A. Morris and David E. Kahen, "The City's Tax Appeals Tribunal Finds a 'Conduit' ", New York Law Journal, Aug. 25, 1999, p. 5, col. 2.

Conclusions

An improvement exchange has been, for quite some time, a very beneficial transaction for exchangers wishing to add value to a replacement property, or as a device to obtain custom improvements while taking advantage of a tax- deferred exchange.

The IRS appears to be opening the door a little wider, by potentially giving exchangers the additional benefit of completing the same type of exchange on property that they may already have an interest in. And while these Private Letter Rulings may signal an intent by the IRS to move in a positive direction, exchangers are reminded to seek competent tax and legal advice as this is a new area.

Todd R. **Pajonas** is President of Legal 1031 Exchange Services, a national Qualified Intermediary for IRC §1031 tax deferred exchanges.

8/18/2003 NYLJ S4, (col. 1)

END OF DOCUMENT