Safe Harbor Build-To-Suit Exchanges
Involving Leasehold Improvements

The following comments represent the individual views of those members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation. These comments were prepared by individual members of the Committee on Sales, Exchanges and Basis. Principal responsibility was exercised by Kelly Alton, Brad Borden and David Shechtman. Substantive contributions were made by Ronold Platner, Lou Weller and Mary Foster. The comments were reviewed by Adam Handler of the Section’s Committee on Government Submissions and by Rudolph Ramelli, Council Director of the Sales, Exchanges and Basis Committee.

Although the members of the Section of Taxation who have participated in preparing these Comments have clients who would be affected by the guidance addressed in these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. Executive Summary

A. Overview

Among the items included in the 2003-2004 Priority Guidance Plan (the “Business Plan”), released by the Treasury Department and the Internal Revenue Service on July 23, 2003, was the following project: “Guidance under section 1031 regarding reverse like-kind exchanges of property.” We understand that the project may deal with reverse exchanges in which the “parked property” consists of improvements constructed on land owned (or previously owned) by either the exchanging taxpayer or a related party. The joint statement accompanying the Business Plan invites the public to provide comments on projects as guidance is developed throughout the year. This letter respectfully submits for your consideration our comments and suggestions regarding the circumstances under which such “parked property” should be respected as valid replacement property under Section 1031 and the safe harbor of Rev. Proc. 2000-37, 2000-2 C.B. 308 (“Rev. Proc. 2000-37”).

Our comments are divided into three parts. The first part provides an overview of build-to-suit exchanges and the requirements of Rev. Proc. 2000-37. The second part discusses in detail build-to-suit exchanges in which the replacement property\(^1\) includes improvements constructed on land owned by a taxpayer\(^2\) and leased to an accommodation party (“Leasehold Improvements Exchanges”). In the second part of our comments, we discuss the legislative purpose and technical requirements of Section 1031 and describe how properly structured Leasehold Improvements Exchanges satisfy both the purpose and technical requirements of Section 1031. We also discuss the tax consequences arising from the possible merger of the taxpayer’s fee interest and leasehold interest upon the completion of a Leasehold Improvements Exchange.

The third part of our comments discuss in detail build-to-suit exchanges in which the replacement property includes improvements constructed on land owned by a related party\(^3\) (as to the taxpayer) and leased to an accommodation party (“RP Leasehold Improvements Exchanges”). In the fourth part, we also discuss the purpose and technical aspects of Section 1031(f) and describe how RP Leasehold Improvements Exchanges can

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1 The terms “relinquished property” and “replacement property” are used herein as defined in Treas. Reg. §1.1031(k)-1(a).

2 As used herein, the term “taxpayer” includes the person or legal entity owning the relinquished property, as well as any other entity which is a “disregarded entity” (within the meaning of Treas. Reg. §301.7701-3) with respect to such person or entity.

3 The term “related party” is used herein as defined in Section 1031(f)(3).
be structured in a manner that does not abuse the relationship between the taxpayer and related party or violate the technical requirements of Section 1031(f). If a transaction satisfies the purpose and technical requirements of Section 1031 and is not abusive, it should be granted Section 1031 non-recognition treatment. We note that in two recent letter rulings the Internal Revenue Service (“IRS”) approved like-kind exchanges structured along the format of an RP Leasehold Improvements Exchange.

For the reasons set forth in our report, we believe the requested guidance should confirm the holdings in the recent letter rulings analyzing RP Leasehold Improvements Exchange structures and extend the same non-recognition treatment to Leasehold Improvements Exchanges.

**B. Summary of Recommendations and Conclusions**

1. The IRS is to be commended for issuing Rev. Proc. 2000-37 in order to provide a degree of “tax certainty” regarding so-called “reverse” or “parking” exchanges under Section 1031. Because taxpayers often find it necessary to structure build-to-suit exchanges as “reverse” or “parking” exchanges, we believe additional guidance (the “BTS Guidance”) is appropriate to clarify the scope of permissible build-to-suit arrangements under Rev. Proc. 2000-37.

2. We recommend that the BTS Guidance confirm the conclusions reached by the IRS in PLR 200251008 and PLR 200329021 with respect to RP Leasehold Improvements Exchanges. That is, such guidance should confirm that the safe harbor of Rev. Proc. 2000-37 applies where an Exchange Accommodation Titleholder (“EAT”) (i) acquires an arms-length 30-year-plus leasehold interest from a taxpayer’s related party, (ii) constructs and owns the improvements on the leased property for which the EAT pays during the maximum 180 “parking period” under Rev. Proc. 2000-37 and (iii) transfers its leasehold interest and improvements to the taxpayer to complete the exchange. We believe properly structured RP Leasehold Improvements Exchanges satisfy the legislative purpose of Section 1031, satisfy the technical requirements of Section 1031 and Rev. Proc. 2000-37, and do not give rise to the abuse which Section 1031(f) was enacted to combat.

3. We recommend that the BTS Guidance extend the holdings in PLR 200251008 and PLR 200329021 to Leasehold Improvements Exchanges where the EAT initially acquires its 30-year-plus leasehold interest not from the taxpayer’s related party but rather from the taxpayer itself (or a “disregarded entity” as to the taxpayer). We

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4 Treas. Reg. §1.1002-1(b).

5 See PLR 200251008 (pursuant to a 32-year arms-length sublease, Exchange Accommodation Titleholder (“EAT”) subleased land from a related party as to taxpayer, constructed and owned improvements and transferred subleasehold interest and improvement to taxpayer to complete exchange); and PLR 200329021 (EAT acquired from taxpayer’s related party a 30-year plus existing ground lease on land owned by a third party, constructed and owned improvements, and transferred leasehold interest and improvements to taxpayer to complete exchange.)
believe properly structured Leasehold Improvements Exchanges also satisfy the legislative purpose of Section 1031, as well as the technical requirements of Section 1031 and Rev. Proc. 2000-37.

4. In the context of the BTS Guidance, we recommend that the IRS reconsider the reasoning in Rev. Rul. 67-255 and Rev. Rul. 76-391 regarding the like-kind status of (i) real property improvements alone to (ii) improved or unimproved land. We believe that the BTS Guidance should acknowledge that real property improvements affixed to the land, and transferred together with an interest in the underlying land, are like-kind to improved or unimproved land. We believe that a transfer of such real property interests as part of an exchange should be contrasted to a situation in which a taxpayer (as opposed to an EAT or other Accommodator) pays for and receives personal property and services incorporated into real property owned at all relevant times by the taxpayer.

5. In the context of the BTS Guidance, the IRS may choose to address the potential merger of the taxpayer’s leasehold interest and fee interest at the conclusion of a Leasehold Improvements Exchange in one of two ways. First, the IRS may conclude that because Rev. Proc. 2000-37 requires only transitory “qualified indicia of ownership” on the part of the EAT, the nominal 30-year-plus interest received by the EAT under its lease with the taxpayer should be respected as a fee-equivalent interest when received notwithstanding that the lease will terminate in 180 days or less. Alternatively, the IRS may conclude that the EAT’s nominal 30-year-plus leasehold interest should be recast as a short-term (i.e., non-fee-equivalent) real property interest, in which case, upon completion of the exchange, the taxpayer should recognize taxable “boot” to the extent, if any, of the fair market value of the EAT’s interest in the short-term lease (but not the value of the EAT’s constructed leasehold improvements).

6. We recommend that the BTS Guidance contrast Leasehold (and RP Leasehold) Improvements Exchanges with transactions in which an EAT pays cash to acquire real property from the taxpayer or the taxpayer’s related party to commence a purported qualified exchange accommodation arrangement under Rev. Proc. 2000-37. The later transactions involve a “cashing out” on the part of the taxpayer or the group consisting of the taxpayer and its related party. As a result, these transactions run afoul of the legislative purpose underlying Section 1031(a) (in the case of a Leasehold Improvements Exchange) or Section 1031(f) (in the case of an RP Leasehold Improvements Exchange) and should be taxable, in whole or in part, depending upon the amount of cash received.


A. Case Law Authorities on Build-To-Suit Exchanges

Our comments analyze Leasehold Improvements Exchanges and RP Leasehold Improvements Exchanges in the context of safe-harbor “reverse” or “parking” exchanges under Rev. Proc. 2000-37. The structure of a typical Leasehold (or RP Leasehold)
Improvements Exchange under Rev. Proc. 2000-37 is described in detail in Appendix A attached hereto. It should be noted, however, that under pre-Rev. Proc. 2000-37 case law, it is well established that a taxpayer may engage another party to acquire real property and construct improvements thereon for the purpose of exchanging such real property and improvements for other real property owned by the taxpayer. Such other party may be either a cooperative buyer of the taxpayer’s relinquished property in a two- or three-party exchange (a “Cooperative Buyer”) or an accommodation party in a four-party exchange (an “Accommodator”). These arrangements are often referred to as “parking” arrangements because the potential replacement property is “parked” with an Accommodator or Cooperative Buyer pending the taxpayer’s disposition of its relinquished property.

For example, in *J.H. Baird Publishing Co. v. Commissioner*, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4, the court upheld a four-party exchange in which a realty company acquired and sold the taxpayer’s relinquished property, acquired land from an unrelated party, constructed improvements thereon to the taxpayer’s specification, and then completed the exchange by transferring the land and improvements to the taxpayer. See also *Coastal Terminals, Inc. v. Commissioner*, 320 F.2d 333 (4th Cir. 1963) and Rev. Rul. 75-291, 1975-2 C.B. 332, each of which approved a build-to-suit exchange in which a Cooperative Buyer purchased land and constructed improvements thereon specifically for the purpose of completing an exchange. Indeed, Treas. Reg. §1.1031(k)-1(e) contemplates that deferred exchanges may involve replacement property not yet produced at the time the taxpayer disposes of its relinquished property and sets forth rules regarding the identification and receipt of such replacement property.

The foregoing cases, and others, have permitted taxpayers great latitude in supervising construction activities and bearing the risk of cost overruns in build-to-suit exchanges qualifying for non-recognition treatment under Section 1031. In these and other cases, the IRS has argued, unsuccessfully, that the Accommodator’s or Cooperative Buyer’s transitory ownership of the replacement property should be ignored on the ground that such entity was acting as the agent of the taxpayer or otherwise lacked sufficient “burdens and benefits” of ownership as to the “parked” replacement property. See, e.g., *Biggs v. Commissioner*, 69 T.C. 905 (1978), aff’d, 632 F. 2d 1171 (5th Cir. 1981). *Cf., DeCleene v. Commissioner*, 115 T.C. 457 (2000) (taxpayer’s attempted pre-safe harbor build-to-suit exchange, through the use of a Cooperative Buyer, does not qualify for non-recognition under Section 1031 where Cooperative Buyer purchased “parked” property from taxpayer -- for an amount exactly equal to the purchase price for taxpayer’s relinquished property - - and taxpayer did not divest himself of beneficial ownership of his formerly-owned property during the “parking” period). For the reasons discussed in the text at Section III B, *infra*, we believe the facts of *DeCleene* are distinguishable from the facts of a typical Leasehold Improvements Exchange.

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6 In these and other cases, the IRS has argued, unsuccessfully, that the Accommodator’s or Cooperative Buyer’s transitory ownership of the replacement property should be ignored on the ground that such entity was acting as the agent of the taxpayer or otherwise lacked sufficient “burdens and benefits” of ownership as to the “parked” replacement property. See, e.g., *Biggs v. Commissioner*, 69 T.C. 905 (1978), aff’d, 632 F. 2d 1171 (5th Cir. 1981). *Cf., DeCleene v. Commissioner*, 115 T.C. 457 (2000) (taxpayer’s attempted pre-safe harbor build-to-suit exchange, through the use of a Cooperative Buyer, does not qualify for non-recognition under Section 1031 where Cooperative Buyer purchased “parked” property from taxpayer -- for an amount exactly equal to the purchase price for taxpayer’s relinquished property - - and taxpayer did not divest himself of beneficial ownership of his formerly-owned property during the “parking” period). For the reasons discussed in the text at Section III B, *infra*, we believe the facts of *DeCleene* are distinguishable from the facts of a typical Leasehold Improvements Exchange.

7 For example, courts have approved transactions involving newly constructed replacement property notwithstanding that (1) the construction was performed in accordance with the taxpayer’s specifications and the taxpayer supervised construction (*Boise Cascade Corp. v. Commissioner*, 33 T.C.M. (CCH) 1443 (1974); *J.H. Baird Publishing Co., supra*; and *Coastal Terminals, supra*); (2) the taxpayer had authority over payment of invoices (*J.H. Baird*); (3) the exchanging party acquired its interest in the replacement property with options assigned by the taxpayer and accepted assignment of construction contracts (*Coastal Terminals*); and (4) the taxpayer, and not the other party to the exchange, was liable for construction costs in excess of a stated amount (*Boise Cascade* and *J.H. Baird*).

In general, Rev. Proc. 2000-37 permits a taxpayer to retain an “exchange accommodation titleholder” or “EAT”\textsuperscript{8} to “park” potential replacement property (and, if so directed by the taxpayer, construct improvements thereon) in order to facilitate a taxpayer’s subsequent like-kind kind exchange.

Under Rev. Proc. 2000-37, (1) the taxpayer and the EAT must enter into a written “Qualified Exchange Accommodation Agreement,” (2) the EAT must acquire “qualified indicia of ownership”\textsuperscript{9} as to the “parked” property, (3) the taxpayer must identify (under rules similar to those of Treas. Reg. §1.1031(k)-1(c)) the potential relinquished property for its exchange no later than 45 days after the EAT acquires qualified indicia of ownership to the “parked” property and (4) no later than 180 days after the EAT acquires qualified indicia of ownership of the “parked” property, the EAT must transfer the “parked” property (typically through a “qualified intermediary”\textsuperscript{10} which has also acquired and transferred the taxpayer’s relinquished property) to the taxpayer as replacement property in the exchange. If the foregoing requirements are met, the IRS will not challenge the status of the EAT as the “tax owner” of the “parked” property even if there exist certain non-arms-length arrangements between the parties which might otherwise undermine the status of the EAT as the beneficial owner of the “parked” property under general tax principles.\textsuperscript{11} Thus, for example, the Taxpayer and the EAT may enter into leases, property management agreements, or loan arrangements on non-arms-length terms pursuant to which the Taxpayer will effectively control the use of the “parked” property during the period in which the EAT holds legal title or other qualified indicia of ownership.

\textsuperscript{8} The EAT must not be the taxpayer or a “disqualified person” and must be subject to federal income tax (or, if the EAT is a pass-through entity for federal income tax purposes, 90 percent of its interests must be held by persons or entities subject to federal income tax). Rev. Proc. 2000-37 §4.02. Rev. Proc. 2000-37 also permits the “parking” of the taxpayer’s relinquished property under certain terms and conditions.

\textsuperscript{9} Under §4.02(1) of Rev. Proc. 2000-37, “qualified indicia of ownership” means legal title to the parked property or other indicia of beneficial ownership of the property under applicable principles of commercial law, such as a contract for deed. “Qualified indicia of ownership” also includes ownership of all the interests in an entity that (i) holds legal title or other indicia of ownership to the parked property and (ii) is disregarded as an entity separate from its owner for federal income tax purposes.

\textsuperscript{10} The term “qualified intermediary” is used herein as defined in Treas. Reg. §1.1031(k)-1(g)(4).

\textsuperscript{11} Rev. Proc. 2000-37, §4.03. As discussed in greater detail in Section II A, supra, the IRS has challenged on agency grounds (albeit without great success) certain pre-Rev. Proc. 2000-37 arrangements in which an Accommodator (or a Cooperative Buyer) acquired and “parked” the potential replacement property desired by the taxpayer to complete its exchange. Rev. Proc. 2000-37 was expressly designed to obviate the need to address the agency issue.
C. Need for Leasehold Improvements Exchanges
For Build-To-Suit Arrangements Under Rev. Proc. 2000-37

In our experience, most taxpayers desiring to effect “reverse” or “parking” exchanges prefer to obtain the certainty afforded by the safe harbor of Rev. Proc. 2000-37. This is the case notwithstanding the following statement in §3.02 of Rev. Proc. 2000-37: “[T]he [IRS] recognizes that ‘parking transactions’ can be accomplished outside the safe harbor provided in this revenue procedure.”

For a build-to-suit exchange, often the most difficult challenge for a taxpayer under Rev. Proc. 2000-37 is the requirement limiting the EAT’s ownership of the “parked” property to a maximum of 180 days. In order to capture the most construction dollars during this period, it is helpful if the EAT can start construction immediately upon acquiring qualified indicia of ownership. To achieve this result, however, it is often necessary for the taxpayer or an affiliate to have acquired ahead of time title to the land on which improvements will be constructed. This allows the taxpayer or its affiliate to begin complying with requirements relating to zoning, permits, environmental studies and similar matters before construction starts. Thus, taxpayers will often need to structure Leasehold Improvements Exchanges or RP Leasehold Improvements Exchanges if they intend to comply with the requirements of Rev. Proc. 2000-37 and capture as replacement property a substantial amount of construction expenditures.

D. Distinction Between Leasehold Transactions and EAT’s Acquisition of Fee

As noted above, our comments address transactions in which an EAT acquires a leasehold interest in real property owned by the taxpayer or a related party and then constructs and owns leasehold improvements on such property. In our view, these transactions differ materially from transactions in which an EAT (i) acquires for cash a fee interest in land owned by the taxpayer or a related party (ii) constructs improvements on the acquired land, and (iii) transfers the land and improvements back to the taxpayer to complete the exchange. In the later transactions, either the taxpayer or the related party has “cashed out” in the transaction by receiving cash from the EAT for the land. Although the EAT’s acquisition of a fee interest technically satisfies the “qualified indicia of ownership” requirement under Rev. Proc. 2000-37, these transactions depart, at least in part, from the legislative purpose of Section 1031(a) (in the case of a purchase from the taxpayer) or Section 1031(f) (in the case of a purchase from a related party) because of the “cash out” aspect.

Our view of the proper taxation of a transaction in which the EAT acquires land from a related party is set forth in Section IV, below. Where the EAT acquires land from the taxpayer, we believe it is proper to analyze the transaction as courts have done in cases involving a Cooperative Buyer’s acquisition of replacement property land from the taxpayer and treat the cash received by the taxpayer from the EAT as taxable “boot” in the exchange.\(^\text{12}\)

\(^{12}\) See Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976), and DeCleene v. Commissioner, supra,
III. Leasehold Improvements Exchanges

A Leasehold Improvements Exchange is a transaction in which a taxpayer disposes of a relinquished property and acquires as its replacement property a long-term leasehold interest in, and improvements constructed on, land owned by the taxpayer. If structured properly, such transactions satisfy the purposes and technical requirements of Section 1031 and are not abusive.

A. The Legislative Purpose of Section 1031

A significant purpose for enacting Section 1031 was Congress’ belief that “if a taxpayer’s money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.” Thus, if the taxpayer is able to demonstrate that it has not cashed out, but its capital is still “tied up in a continuing investment of the same sort,” the taxpayer’s exchange should satisfy the legislative purpose of Section 1031.

A means of determining whether a taxpayer’s money is still tied up in a continuing investment is to compare the taxpayer’s position before the transaction with the taxpayer’s position after the transaction. The application of this test is best demonstrated with an example. Assume Taxpayer X owns real property, Property A, which is worth $150,000. Taxpayer X transfers Property A to an unrelated party in exchange for like-kind Property B, which is also worth $150,000. Even though the transfer of Property A and the receipt of Property B do not occur simultaneously, if they are part of an interdependent transaction, Taxpayer X continues an investment of the same sort and should not be required to recognize gain or loss on the transaction. On the discussed, respectively, in footnote 24, infra, and footnote 6, supra, and the accompanying text.


14 Jordan Marsh Co. v Commissioner, 269 F.2d 453, 456 (2d Cir. 1959).

15 See Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935); Hayden v. Commissioner, 165 F.2d 588 (5th Cir. 1950); but see Carlton v. Commissioner, 395 F.2d 238 (5th Cir. 1967), and Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968) (the actual or constructive receipt of non-like-kind property disqualifies the transaction, even if the taxpayer’s intent and the end result demonstrate a desire to effect a Section 1031 exchange).

16 Section 1031(a)(3); Starker v. United States, 602 F.2d 1241 (9th Cir. 1979), and Fred L. Fredericks v. Commissioner, 67 T.C.M. (CCH) 2005 (1994).

17 Bauer v. Commissioner, 74 T.C. 1134 (1980), and Biggs v. Commissioner, 69 T.C. 905 (1978), aff’d, 632 F.2d 1171 (5th Cir. 1980).
other hand, if, in exchange for Property A, Taxpayer X were to receive Property C worth $100,000 and cash of $50,000, Taxpayer X has cashed out its investment, at least in part, and should be required to recognize realized gain to the extent of the cash received.\(^\text{18}\)

A snapshot before the transaction reveals that Taxpayer X owned $150,000 of real property. A snapshot after the transaction reveals whether Taxpayer X has continued an investment or has cashed out.

### Continuation of Investment

<table>
<thead>
<tr>
<th>Before</th>
<th>After</th>
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<tbody>
<tr>
<td>Real Property A = $150,000</td>
<td>Real Property B = $150,000</td>
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### Partial Cash Out

<table>
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<th>Before</th>
<th>After</th>
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<tbody>
<tr>
<td>Real Property A = $150,000</td>
<td>Real Property B = $100,000</td>
</tr>
<tr>
<td>Cash = $50,000</td>
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</table>

This simple test determines whether the taxpayer continues an investment in like-kind property as part of an exchange, and should be used in analyzing whether a Leasehold Improvements Exchange satisfies this purpose of Section 1031. As shown below, a Leasehold Improvements Exchange can be structured to ensure no cash is taken out tax-free and to otherwise satisfy the technical requirements of Section 1031.

### B. Technical Requirements of Section 1031

Since the enactment of Section 1031, Congress, the courts, and the IRS have developed technical requirements that a taxpayer must satisfy to qualify for Section 1031 nonrecognition treatment. Section 1031(a)(1) provides that a transaction qualifies for nonrecognition treatment if (1) it is an exchange (2) of like-kind properties (3) that are held by the taxpayer for productive use in a trade or business or for investment. In examining Leasehold Improvements Exchanges, we assume that the properties involved are held for productive use in a trade or business or for investment and focus solely on the exchange requirement and the like-kind property requirement.

#### 1. The Exchange Requirement

The exchange requirement is satisfied if there is a “reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.”\(^\text{19}\) A

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\(^{18}\) Section 1031(b) and (c) (realized gain must be recognized to the extent of boot received, but loss is disallowed).

\(^{19}\) Treas. Reg. §1.1002-1(d).
taxpayer fails to satisfy the exchange requirement if it receives or obtains control of cash or other non-like-kind property as part of the transaction. Thus, if the taxpayer obtains control of cash or other non-like-kind property as part of a transaction, the transaction does not qualify for Section 1031 nonrecognition treatment, even if the taxpayer can demonstrate that it intended to reinvest the cash or other non-like-kind property in like-kind replacement property. By structuring a transaction within one of the safe harbors in the Section 1031 regulations, the taxpayer can ensure that it does not actually or constructively receive cash or other non-like-kind property before the exchange is completed.

In the Leasehold Improvements Exchange context, the challenge is to ensure the taxpayer is deemed to acquire like-kind replacement property from another person in exchange for the taxpayer’s transfer of its relinquished property. The transfer of property in exchange for construction services and building materials does not qualify for nonrecognition treatment. Moreover, the taxpayer cannot acquire property from itself as part of a nonrecognition transaction. As discussed in Section II A, supra, a taxpayer may, however, acquire newly-constructed improvements and the underlying property as part of a Section 1031 exchange, even if the taxpayer oversees the construction of the improvements, provided that the improvements qualify as real property under local law at the time the property is received. Thus, for a Leasehold Improvements Exchange to qualify for Section 1031 nonrecognition treatment, the taxpayer must acquire the improved property from a party other than itself.

Relying upon the safe harbor in Rev. Proc. 2000-37, a taxpayer should be able to structure a Leasehold Improvements Exchange in a manner that qualifies for Section 1031 nonrecognition treatment. The most basic Leasehold Improvements Exchange involves the taxpayer leasing raw land to an EAT for more than 30 years, the taxpayer directing the EAT to construct improvements on the leased property, and the taxpayer then transferring (typically through a qualified intermediary) its relinquished property in exchange for the improvements and leasehold interest, which must have more than 30 years to run at the time of acquisition.

20 65 CONG. REC. 2799 (1924).
22 Treas. Reg. §1.1031(k)-1(g)(1).
23 Treas. Reg. §1.1031(k)-1(e).
24 Smith v. Commissioner, supra (taxpayer may not acquire as replacement property land he previously owned despite purported pre-exchange transfer to Cooperative Buyer who also was taxpayer’s brother; taxpayer “cashed out” of transaction when brother paid cash purchase price). See also discussion of DeCleene v. Commissioner, supra, at footnote 6.
25 Treas. Reg. §1.1031(k)-1(e)(3).
26 Treas. Reg. §1.1031(a)-1(c) (a leasehold of a fee with 30 years or more to run is like-kind to real estate).
By entering into a long-term lease with an EAT, the taxpayer does not transfer the property to the EAT. Instead, the EAT becomes a lessee, and the lease agreement, if properly drafted, will provide that the lessee will be the owner of any improvements constructed by the lessee. Because Rev. Proc. 2000-37 provides that the EAT will be treated as the owner of property to which it holds qualified indicia of ownership, the EAT should be treated as owning a leasehold interest in the land and owning any improvements constructed while it is the lessee. To ensure that the lease is a bona fide lease, the lease agreement should require the payment of fair market rent. Because fair market rent is required, there should be no transfer of value with respect to the lease itself.

At the close of the transaction, the taxpayer may receive from the EAT (typically through a qualified intermediary) an assignment of the EAT’s leasehold interest and the EAT’s leasehold improvements.

An example demonstrates how this type of transaction also satisfies the purpose of Section 1031 by allowing the taxpayer to continue an investment in like-kind property. Assume Taxpayer owns Property A worth $150,000 and Property B worth $10,000. Taxpayer leases Property B to an EAT for 32 years with no rent required during the construction period. While leasing the property, the EAT constructs a building worth $150,000 on the leased property. Taxpayer transfers Property A to an unrelated party using a qualified intermediary and directs that the exchange proceeds be used to acquire the lease and the constructed leasehold improvements from the EAT (through the qualified intermediary) for $150,000.

Snapshots of Taxpayer’s position before and after the transaction reveal that Taxpayer has continued an investment in like-kind property without cashing out.

**Continuation of Investment**

<table>
<thead>
<tr>
<th>Before</th>
<th>After</th>
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<tbody>
<tr>
<td>Property A =  $150,000</td>
<td>Improved Property B = $160,000</td>
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<tr>
<td>Property B =  10,000</td>
<td></td>
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<tr>
<td>Total Real Estate =  $160,000</td>
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Because there was no cashing out and because taxpayer has acquired a like-kind interest (see Section III A, *infra*.), the transaction satisfies the purpose of Section 1031.

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28 We note that many arms-length commercial ground leases do not require the tenant to pay ground rent during the construction period. If ground rent is charged during the construction period, the rent would be capitalized into the basis of the property by the EAT and would increase the value of the EAT’s “parked” property.
Assuming that all the requirements in Rev. Proc. 2000-37 are satisfied, the EAT should be treated as the tax owner of the leasehold interest and the improvements. This distinguishes a Leasehold Improvements Exchange from the facts in *Bloomington Coca-Cola Bottling Co. v. Commissioner* where the purported Accommodator never acquired a fee or fee-equivalent interest in the taxpayer-owned property on which it constructed improvements. Unlike the taxpayer in *Bloomington Coca-Cola*, here the taxpayer transfers Property A and in exchange acquires the leasehold interest in Property B and improvements, making the transaction a reciprocal transfer of property, satisfying the exchange requirement. See Section III B, *infra*.

In addition to satisfying the exchange requirement and continuity of investment purpose of Section 1031, many build-to-suit exchanges are custom-made for Section 1031 treatment, as discussed in Section II C, *supra*. It is often the case in the build-to-suit exchange context for a taxpayer to relocate business operations from one property to another. For example, a manufacturer may experience increased demand for its product and, as a result, outgrow its old facilities. If the manufacturer already owns real property on which it desires to build new and improved facilities, it may wish to dispose of the old facilities and use the proceeds to construct new facilities on its existing real property. Because the taxpayer is simply relocating business operations due to a business exigency and continues its investment in like-kind property, it is not appropriate to tax the taxpayer on this transaction.30

Finally, the IRS would create an inequity if a taxpayer who otherwise satisfies the technical requirements of Section 1031 must recognize gain on a Leasehold Improvements Exchange while the taxpayers in *Coastal Terminals* and similar cases, as well as the taxpayers engaging in RP Leasehold Improvements Exchanges (which, as discussed in Section IV, the IRS has approved in two recent letter rulings), are permitted to defer gain under Section 1031. Such disparate treatment penalizes taxpayers for acquiring land directly before improvements are to be constructed thereon. To avoid this result and more fully embrace the purpose of Section 1031, the IRS should provide guidance stating that it will treat an EAT as the owner of a leasehold interest acquired on taxpayer-owned land and any improvements constructed by the EAT. A taxpayer should be allowed to receive such property as valid replacement property in a Leasehold Improvements Exchange.

### 2. The Like-Kind Property Requirement

When the taxpayer completes a Leasehold Improvements Exchange, it acquires a leasehold interest and improvements from the EAT. The leasehold interest and improvements should be like-kind to other real estate that the taxpayer relinquishes.

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29 189 F.2d 14 (7th Cir. 1951), aff’g 8 T.C.M. (CCH) 666 (1950). The rationale for the *Bloomington Coca-Cola* holding is discussed in greater detail at footnote 32 and the accompanying text.

Treas. Reg. §1.1031(a)-1(b) states: “The 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(c)(2) references “exchanges of improved real estate for unimproved real estate” as an example of exchanges of like-kind property. These provisions clearly provide that real estate improvements, received by themselves or with an interest in the underlying land, are like-kind to other real estate.

Nevertheless, in Rev. Rul. 67-255, 1967-2 C.B. 243, and Rev. Rul. 76-391, 1976-2 C.B. 243, rulings under Section 1033(g), the IRS concluded that improvements constructed on land owned by the taxpayer are not like-kind to other real estate. Even if these rulings are correct, the facts in a properly structured Leasehold Improvements Exchange differ from the facts in the Section 1033(g) rulings in that the EAT, and not the taxpayer, purchases the materials and services required to build the improvements.

Therefore, the taxpayer does not acquire the materials or services piecemeal as was the case in the rulings and in Bloomington Coca Cola Bottling Co. v. Commissioner, supra. Instead, the taxpayer acquires constructed improvements that are affixed to the property. Additionally, the taxpayer acquires a lease of the underlying land with the improvements.

Moreover, in Davis v. United States, the only case to consider the validity of the IRS’s conclusion in the two Section 1033(g) revenue rulings, the district court disagreed.

It is well established that land and the land improvements thereupon are separate properties and can be conveyed separately if the transaction is structured properly. See, e.g., Minneapolis Syndicate v. Commissioner, 13 B.T.A. 1303 (1928), acq., VIII-1 C.B. 31; Waldrep v. Commissioner, 52 T.C. 640 (1969); Sanderson v. Commissioner, T.C. Memo 1985-477; Bratton v. Roundtree, 37 A.F.T.R. 2d ¶76-438 (M.D. Tenn. 1976); PLR 9026033; PLR 8433003. Further, the IRS previously approved a like-kind exchange of land improvements (without a transfer of the underlying real property) for real property. See PLR 8008113. Although it is clear in this ruling that the replacement “Exchange Properties” are real property, the IRS did not limit the “Exchange Properties” to real property improvements, noting instead that the improvements at issue are real property under the applicable state law. See discussion at Section III B2 infra. See also PLR 200137032 (holding that condominium interest that comprised a fee interest in an apartment, the underlying real property, and the common areas of the apartment building was like kind to an interest in a cooperative housing corporation which gave the owner of the shares the right to occupy the same apartment).

Although this case is commonly cited for the proposition that a taxpayer cannot build replacement property upon its own land, the case actually holds that the transaction at issue was a sale and not an exchange. Further, the IRS has not cited this case either for the proposition that land and land improvements alone are not like-kind or that a taxpayer cannot build replacement property on its own land. In the two private letter rulings which cite Bloomington Coca-Cola, the IRS has relied on this case solely for the proposition that the transaction did not constitute an exchange. See PLR 9031015; PLR 8701015. Indeed, it is noteworthy that the taxpayer in Bloomington Coca Cola merely engaged a contractor to construct a new plant on the taxpayer’s land, agreeing to pay the contractor $64,500 and deed to the contractor the taxpayer’s old plant, valued at $7,500. There was no indication that the taxpayer desired to effect an exchange, and the taxpayer initially reported the transaction as taxable in order to recognize a loss. Later, when it became apparent to the taxpayer that it would benefit more from exchange treatment (the year at issue having become a base year for determination of the wartime excess profits tax), it amended its return to report an exchange with no loss recognized.

411 F. Supp. 964 (D.C. Hawaii, 1976), aff’d on other grounds, 589 F.2d 446 (9th Cir. 1979) (holding that...
with the IRS’s conclusion on the definition of like-kind property. In *Davis*, the taxpayers used the proceeds from involuntarily converted land to construct on other land owned by them a storm drainage and water system, grade the land, and excavate a roadway. The district court ruled “that the improvements made by the taxpayers represent a substantial continuation of their prior commitment of capital and that these improvements qualify for non-recognition of gain as real property of ‘like-kind’ to the property condemned as required by [Section 1033(g)].” On appeal, the Ninth Circuit held that the improvements constructed by the taxpayer were “similar or related in use” to the condemned land for purposes of Section 1033(a) and thus did not need to address the Section 1033(g) issue.

Because Section 1033 lacks an “exchange” requirement, the precise issue addressed by the district court in the *Davis* case (i.e., the like-kind status of constructed improvements on taxpayer-owned land) does not apply in a Section 1031 exchange where a party other than the taxpayer must acquire some recognizable interest in the land underlying the improvements in order to engage in an exchange of real property interests, as opposed to a contract for production services.

Indeed, an analysis of a fairly typical exchange of raw land for land and improvements leads one to conclude that where real estate improvements are transferred in an exchange of real property interests, the improvements are like-kind to unimproved land or land with improvements. It is well established that if a taxpayer transfers raw land in exchange for a ranch consisting of land and machinery, the machinery, as personal property, will not be like-kind to the transferred land; and thus the taxpayer receives taxable “boot” under Section 1031(b) and (c) equal to the value of the machinery. If, in fact, real property improvements were not of a like-kind to raw land, an exchange of raw land for land with improvements likewise would give rise to taxable boot equal to the value of the improvements. Because long-standing regulations provide that improved real property is like kind to unimproved real property, such a result is untenable.

A private letter ruling in the Section 1031 context demonstrates the IRS’s willingness to treat improvements as like-kind to other real estate. In PLR 8008113, the taxpayer transferred improvements and leased the underlying land to an unrelated party for 35 years. In exchange, the taxpayer received a fee interest in other property. The IRS ruled that the “improvements that are affixed to the land are real property under the applicable state law. Therefore, the improvements of the shopping center which are exchanged for a fee simple interest in the Exchange Properties satisfy the ‘like-kind’ requirements of Section 1031.” Thus, although Rev. Rul. 67-255 and Rev. Rul. 76-391 create some confusion about this issue, it appears – based on the applicable regulations

the transaction came within Section 1033(a)).


35 See Treas. Reg. §1.1031(a)-1(b) and §1.1031(a)-1(c)(2), discussed at Section III B2, *supra*.

36 See footnote 31 *supra*.
and IRS’s position in other rulings – that real estate improvements affixed to land are of the same nature and character as unimproved real estate when the improvements are transferred as part of an exchange of real property interests.\(^{37}\)

\(^{37}\) Note that the *holdings* in Rev. Rul. 67-255 and Rev. Rul. 76-391 are probably correct because the taxpayers received personal property and services that were incorporated into real property, rather than the real property itself. However, we believe that the reasoning of the two rulings, that improvements are not like-kind to land, is flawed. The rulings should have held that the replacement property (the improvements) was not like-kind to real property because the taxpayer acquired replacement property in the form of personal property and services that were incorporated into real property, rather than real property itself. The fundamental problem, discussed below, is that Section 1033 allows a taxpayer to construct its replacement property and Section 1031 does not. Nevertheless, the IRS apparently felt bound by Section 1033 concepts when interpreting the Section 1031 like-kind standard in the context of those rulings.

Modification of the reasoning of these revenue rulings is necessary to make the rulings consistent with the Section 1031 regulations. Treas. Reg. §1.1031(a)-1(b) provides, in defining “like-kind,” that “the 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.” This statement clearly indicates that improved real estate and unimproved real estate should be considered like-kind in all cases; and the regulations, without qualification, provide as an example of a like-kind exchange of property, an exchange of improved real estate for unimproved real estate. Treas. Reg. §1.1031(a)-1(c). Thus, given that improved real estate is like-kind to unimproved real estate, it follows that both of the components of the improved real estate -- the land and the improvements to the real estate -- should be considered like-kind to the unimproved real estate, so long as the improvements are considered real property, rather than personal property, under state law.

Further, it appears that Rev. Rul. 67-255 is a companion ruling to Rev. Rul. 67-254, 1967-2 C.B. 269, also a Section 1033 ruling. Although both rulings involve condemnations of real estate, Rev. Rul. 67-254 involves the application of Section 1033(a)(2) with its more limited standard of “similar or related in service or use,” whereas Rev. Rul. 67-255 involves the application of Section 1033(g) and its “like-kind” standard, which is limited solely to conversions by condemnation. In Rev. Rul. 67-254, the IRS held that a taxpayer’s use of its real property condemnation proceeds to rearrange its plant facilities and construct a garage for its plant on nearby land that it already owned qualified as the acquisition of property similar or related in service or use under Section 1033(a)(2).

Treas. Reg. §1.1033(g)-1(a) specifically cross-references Treas. Reg. §1.1031(a)-1(b) for “principles in determining whether the replacement property is property of like-kind.” Viewed in this context, it appears that the issuance of Rev. Rul. 67-254 may have been the motivation for the issuance of Rev. Rul. 67-255, which can be seen as an attempt by the IRS to produce the same outcome whether the taxpayer acquired replacement property under Section 1033(a)(2) or under Section 1033(g). However, unlike Section 1031, Section 1033 clearly allows taxpayers to have replacement property built for them, so long as the replacement property is acquired by purchase, or to build replacement property themselves. See Treas. Reg. §1.1033(a)-2(c)(4); Rev. Rul. 70-265, 1970-1 C.B. 170. Thus, the IRS may have felt constrained by Section 1033 concepts and thought that the like-kind property standard, when applied to conversions under Section 1033(g), must also allow the replacement property to be constructed by the taxpayer. The IRS also may have thought that the only way to prevent a taxpayer whose real property was condemned from using the more lenient like-kind standard of Section 1033(g) to construct improvements that did not meet the similar or related in service or use test was to hold that the improvements were not like-kind to the condemned land.

We suggest that it is appropriate to modify the reasoning of the rulings to clarify that the taxpayer has received services and personal property, which were incorporated into real property, rather than real property, and that services and personal property are not like-kind to real property, citing Treas. Reg. §1.1031(k)-1(e).
C. Effect of Taxpayer’s Continuing Ownership of the Fee in a Leasehold Improvements Exchange

1. Merger Issue. In a Leasehold Improvements Exchange, it is possible that the leasehold interest the taxpayer receives from the EAT may, as a matter of state law, merge with the taxpayer’s fee interest in the property upon completion of the qualified exchange accommodation arrangement. This possible merger of taxpayer’s fee interest and leasehold interest raises the issue of whether the EAT’s leasehold interest should be respected as a true 30-year-plus lease inasmuch as the parties’ expectation is that the lease will exist as a separate real property interest for 180 days or less.

2. Acquisition of Existing Leasehold Interest on Taxpayer-Owned Property. In both a published and a private ruling, the IRS has confirmed that an existing long-term leasehold interest in replacement property will qualify as like-kind to a taxpayer’s relinquished real property notwithstanding that the taxpayer at all times holds the underlying fee interest in such replacement property. In the published ruling, Rev. Rul. 68-394, 1968-2 C.B. 338, a Section 1033(g) condemnation ruling, the IRS applies the Section 1031 regulations to a transaction in which the taxpayer used part of its condemnation proceeds from one fee-owned property to acquire from his lessee a leasehold interest with a remaining term of 45 years on other fee-owned property of the taxpayer. The ruling holds:

   It is not material that the taxpayer acquired the leasehold on property already owned by him so long as he acquired it in an arms-length transaction. By purchasing the outstanding leasehold, the taxpayer acquired the right to enjoy the possession of this land prior to the time he would have come into its possession under the terms of the lease. Therefore, the acquisition of this right constitutes a replacement of property of like-kind….

   In the private letter ruling, also interpreting Section 1033(g), the IRS relied upon Rev. Rul. 68-394 in concluding that a taxpayer could use the condemnation proceeds from fee-owned real property to acquire two existing long-term leasehold interests held

38 State laws vary as to whether or not this merger occurs by operation of law when the same person or entity owns the fee interest and the leasehold interest. Note, however, that a technical merger of title will not occur if (i) the EAT leases the property from the taxpayer but thereafter transfers the lease and the improvements to a disregarded entity with respect to the taxpayer; (ii) the EAT leases the property, not from the taxpayer, but rather from a disregarded entity with respect to the taxpayer and thereafter assigns the lease to the taxpayer or (iii) the EAT establishes its own disregarded entity to enter into the lease and construct improvements and thereafter transfer 100% of the interests in such entity to the taxpayer. See PLR 9751012 and PLR 9911033 (taxpayer may use “disregarded entity” to acquire replacement property in a Section 1031 exchange). See also PLR 200118023 (purchase of 100% of the membership interests in a single member limited liability company treated as purchase of the LLC’s assets for Section 1031 purposes).
by taxpayer’s subsidiary corporation in other real property as to which the taxpayer owned the fee. In each instance, the taxpayer represented that the leasehold interest would be acquired in an arms-length transaction based upon the valuation of an independent appraiser; and in one case, the subsidiary would continue to manage the day-to-day operation and maintenance of the replacement property after the transfer of its leasehold interest pursuant to an arms-length management agreement with the taxpayer. PLR 9543038. 39

The IRS’s holdings in Rev. Rul. 68-394 and PLR 9543038 are consistent with the holdings of other private and published rulings in which the IRS has recognized that separate “like-kind” interests may exist with respect to the same parcel of real property. For example, Rev. Rul. 76-301, 1976-2 C.B. 241, holds that a taxpayer’s exchange of its leasehold interest in an entire building and improvements for cash and an identical subleasehold interest in a portion of the building constitutes a like-kind exchange on which the taxpayer may not recognize a loss. Similarly, in PLR 9620010 the IRS approved re-investment in replacement land and improvements of condemnation proceeds from a fee interest in other land notwithstanding the taxpayer’s prior ownership of a lessee’s interest in the replacement property. The ruling applied a like-kind test under Section 1033(g).

3. Acquisition of Newly-Created Leasehold Interest. While various published and private rulings have afforded non-recognition treatment to exchanges in which (i) the taxpayer acquired as replacement property a pre-existing long-term leasehold interest on property owned in fee by the taxpayer or (ii) the taxpayer acquired as replacement property a newly created leasehold interest held by an Accommodator on property temporarily leased by the Accommodator under a long-term lease from a party other than the taxpayer, there is virtually no authority considering an exchange in which the replacement property is a leasehold interest in property leased by Accommodator from the taxpayer under a newly created long-term lease. 40

As noted above, the possible transitory nature (i.e., 180 days or less if the lease merges with the fee) of the EAT’s newly-created leasehold interest in a Leasehold Improvements Exchange raises the issue of whether the EAT’s interest should be

39 In PLR 9543038, the leasehold interest acquired as replacement property had been in existence for over seven years, and the IRS suggested that it might have reached a different conclusion if the leasehold interest were newly created. Nevertheless, as noted in Sections II B and II C of the text above, the use of Accommodators who acquire only transitory ownership of “parked” replacement property is well established under Section 1031 both before and after Rev. Proc. 2000-37. In addition, the IRS has approved an Accommodator’s acquisition of a newly created leasehold interest (and the construction of a building thereon as a leasehold improvement) on land owned by a party unrelated to the taxpayer notwithstanding the Accommodator’s transitory ownership of the newly created leasehold interest. See PLR 9149018 and PLR 9110007.

40 One private letter ruling, PLR 8304022, considered such a transaction in which a Cooperative Buyer obtained a 30-year-plus newly-created leasehold interest on land owned by the taxpayer and constructed a parking garage thereon prior to completing an exchange for other fee-owned property of the taxpayer. The IRS approved the transaction for non-recognition treatment under Section 1031 albeit with limited analysis.
respected as a 30-year-plus, fee-equivalent interest for purposes of Treas. Reg. §1.1031(a)-1(c). Arguably, it is not inconsistent with the “qualified indicia of ownership” requirement of Rev. Proc. 2000-37 to treat the EAT’s leasehold interest as fee-equivalent, notwithstanding its transitory nature, if the stated term of the lease exceeds thirty years at the time of transfer to the taxpayer. Moreover, even if the EAT’s lease were re-characterized as merely a 180-day-or-less lease (and therefore not like-kind to a fee), the EAT’s constructed leasehold improvement should nevertheless qualify as like-kind to the taxpayer’s relinquished real property because the EAT will construct and own the improvements while it has an ownership interest in the underlying land (albeit not a like-kind interest). See Section II B2, supra. If, indeed, the EAT’s leasehold interest is treated as short-term, and thus not like-kind to a fee, then the taxpayer should recognize taxable “boot,” if any, based on the fair market value of the EAT’s ground lease interest. If the ground lease contains arms-length terms, then the ground lease should be considered to have no value or minimal value.

D. “Safe-Harbor” Exchanges versus “Non-Safe Harbor” Leasehold Improvements Exchanges

For the reasons discussed above in this Section III, we believe that prior to the publication of Rev. Proc. 2000-37 a taxpayer could have engaged a Cooperative Buyer or an Accommodator (recognized as the owner under general tax principles) to help facilitate a deferred like-kind exchange (through a QI) by (i) acquiring a long-term leasehold interest in land owned by the taxpayer, (ii) constructing and owning leasehold improvements on the land and (iii) transferring its leasehold interest and improvements to the taxpayer (through the QI) to complete the exchange. To the extent that Rev. Rul. 67-255 and subsequent Section 1033(g) rulings suggest otherwise, we believe the scope of those rulings should be limited to situations where the taxpayer simply pays for construction services and materials (personal property) as opposed to situations where a Cooperative Buyer or Accommodator pays for and owns real property improvements affixed to the land.

Similarly, a taxpayer today could engage a Cooperative Buyer or an Accommodator to effect a Leasehold Improvements Exchange outside the scope of Rev. Proc. 2000-37 (e.g., because the Accommodator will hold its leasehold interest for more than 180 days). In these “non-safe harbor” transactions, however, the taxpayer would have to demonstrate that the Cooperative Buyer or Accommodator, unlike the Cooperative Buyer in DeCleene, supra, acquired not just legal title to a real property interest but also an appropriate level of the “burdens and benefits” of real property ownership to qualify as the “beneficial owner” under general tax principles.

41 Along these lines, the EAT’s interest in a long-term lease is no less transitory than an EAT’s fee ownership of “parked” property in a standard qualified exchange accommodation arrangement where, through a put or similar arrangement, the EAT is obligated to transfer its “parked” fee interest to the taxpayer on or before 180 days after the EAT acquires title. See Rev. Proc. 2000-37, Section 4.03(6).

42 See footnote 37, supra, and accompanying text

43 115 T.C. 457, 461.
By contrast, in a “safe harbor” transaction meeting all the requirements of Rev. Proc. 2000-37 (including the 180 day limitation), a taxpayer who engages an EAT to effect a Leasehold Improvements Exchange need demonstrate only that the EAT acquired legal title to its real property interest and that the taxpayer (again, unlike the taxpayer in DeCleene) has not otherwise “cashed out” in the exchange. (See Section II D, supra.) Thus, by permitting a taxpayer and an EAT to engage in a Leasehold Improvements Exchange, the IRS would not be permitting a type of exchange otherwise prohibited prior to the publication of Rev. Proc. 2000-37. Rather, consistent with the intention of Rev. Proc. 2000-37, a taxpayer who can comply with all the “safe harbor” requirements would not need to demonstrate that the EAT, as lessee under its lease and owner of its leasehold improvements, acquired “beneficial ownership” of a real property interest.

E. Recommendation Regarding Leasehold Improvements Exchanges

Leasehold Improvements Exchanges can be structured under the Rev. Proc. 2000-37 safe harbor to satisfy both the legislative purpose and technical requirements of Section 1031. We recommend that the IRS publish guidance stating that it will not challenge the nonrecognition treatment of such transactions. The guidance should provide that a taxpayer may lease or sublease property owned by the taxpayer to an EAT, and then acquire as replacement property, in exchange for other real property, the EAT’s leasehold interest and any improvements constructed on the leased property by the EAT. If the IRS believes that the transitory nature of the EAT’s leasehold interest should cause it to be recast as a short-term lease, then a Leasehold Improvements Exchange should be treated as a proper Section 1031 exchange with taxable “boot” to the extent, if any, of the separate value of the EAT’s ground lease interest.

IV. RP Leasehold Improvements Exchanges

A RP Leasehold Improvements Exchange is a transaction in which a taxpayer transfers relinquished property (typically through a qualified intermediary) to an unrelated party and uses the exchange proceeds to acquire from an EAT leasehold improvements constructed on land leased by the EAT from a related party as to the taxpayer. The typical structure for an RP Leasehold Improvements Exchange is described in Appendix A hereto. If structured properly using the Rev. Proc. 2000-37 safe harbor, the taxpayer should be allowed to acquire the improvements and a leasehold interest in the related party’s property in a non-recognition transaction under Section 1031.44 The main issue to address in the RP Leasehold Improvements Exchange context is whether such a transaction results in the abuse Section 1031(f) was enacted to prevent. Thus, a discussion of RP Leasehold Improvements Exchanges requires a discussion of Section 1031(f) in general.

44 Indeed, the IRS has already granted nonrecognition treatment in two such situations. See PLR 200251008 and PLR 200329021 discussed at footnote 5, supra. Moreover, two of the pre-Rev. Proc. 2000-37 build-to-suit cases discussed in Section II A, supra, involved a Cooperative Buyer’s acquisition of land from a party related to the taxpayer, albeit in transactions which predated the enactment of Section 1031(f). See Boise Cascade, supra, and Coastal Terminals, supra, discussed at Section II A.
A. **Section 1031(f)**

Section 1031(f) was enacted in 1989\(^\text{45}\) in an attempt to curtail certain abuses. Section 1031(f) was fashioned after Section 453(e) (relating to the installment method of reporting gain), which accelerates the gain reportable by the original seller if an installment sale between related parties is followed by certain dispositions of the property by the transferee.\(^\text{46}\) In enacting Section 1031(f), Congress was concerned that:

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, “cashed out” of the investment, and the original exchange should not be accorded nonrecognition treatment.\(^\text{47}\)

Therefore, the purpose of Section 1031(f) is to prevent basis shifting and a subsequent tax-free cashing out.\(^\text{48}\) In considering the proper treatment of RP Leasehold Improvements Exchanges, the IRS should consider the applicability of the Section 1031(f) principles affecting related parties.

B. **Section 1031(f)(1)**

Section 1031(f)(1) provides that if a taxpayer exchanges property with a related party in a transaction that qualifies for Section 1031 nonrecognition treatment and within two years after the exchange, either the taxpayer or the related party transfers one of the exchange properties, “there shall be no nonrecognition of gain or loss under [Section 1031] to the taxpayer with respect to such exchange . . . .” The following example demonstrates the application of Section 1031(f)(1).

Assume individual B owns Property B worth $1,000,000 with an adjusted basis of $200,000. Related party C owns Property C worth $1,000,000 with an adjusted basis of $950,000. If B were to sell Property B for cash, she would recognize gain of $800,000.

\(^{45}\) P.L. 101-239, Section 7601(a).


\(^{47}\) H.R. REP. 101-247, Id. at 1340.

\(^{48}\) See also H.R. CONF. REP. No. 386, 101\(^\text{st}\) Cong., 1\(^\text{st}\) Sess. 613 (1989) (“If related parties engage in a like-kind exchange, tax basis is shifted between properties, which may result in the reduction of tax upon the subsequent disposition of a property.”).
B may try to avoid this gain by first transferring Property B to C in a Section 1031 exchange for Property C. As a result of the exchange, C would take an adjusted basis in Property B of $950,000.49 A subsequent disposition of Property B by C would allow B and C to avoid $750,000 of gain (B’s $800,000 deferred gain less C’s $50,000 recognized gain) by exchanging properties.50 Section 1031(f)(1) prevents this result if either B or C transfers one of the properties within two years after the exchange.51 If Section 1031(f)(1) applies, the exchange will not qualify for Section 1031 nonrecognition treatment. Thus, Section 1031(f)(1) “bumps” the transaction out of Section 1031, into Section 1001. Under Section 1001(c) “the entire amount of gain or loss, determined under [Section 1001], on the sale or exchange of property shall be recognized.” The amount of such gain shall be equal to the difference between the basis each party had in his respective property and the respective property’s fair market value.52 Both the taxpayer and the related party recognize the gain in the year of the subsequent disposition.53

C. Section 1031(f)(2)

Not all dispositions of exchange property following exchanges with a related party destroy Section 1031 nonrecognition treatment. Section 1031(f)(2) provides that dispositions following the death of the taxpayer or the related party and certain involuntary conversions are not taken into consideration (i.e., are treated as non-dispositions) for purposes of Section 1031(f)(1).54 In addition, Section 1031(f)(2)(C), provides that if “it is established to the satisfaction of the Secretary that neither the exchange nor [the subsequent] disposition had as one of its principal purposes the avoidance of Federal income tax[,]” the subsequent disposition shall not be taken into account. Thus, to come within Section 1031(f)(2)(C), the taxpayer must establish that it had a non-tax avoidance motive for both the exchange and the subsequent disposition.55

49 Section 1031(d).

50 It is also possible that the IRS could challenge this transaction under the step transaction or the substance-over-form doctrines.

51 See FSA 200137003 (IRS National Office held that the two-year period is a safe harbor and any transfers thereafter do not trigger Section 1031(f)(1)). The two-year period is suspended if either property holder’s risk of loss with respect to the property is substantially diminished under Section 1031(g).

52 Section 1001(a) and (b).

53 Section 1031(f)(1) (flush language).

54 Section 1031(f)(2)(A) and (B).

55 In applying Section 1031(f)(2), it is important to distinguish between what Congress considers to be a non-disposition and a non-abusive disposition. For example, the House Report states: A disposition would include, however, all other transfers of the property, such as tax-free transfers to a corporation (pursuant to [Section] 351) or to a partnership (pursuant to [Section] 721), unless it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax.”
D. **Section 1031(f)(4)**

Section 1031(f)(4) provides that Section 1031 “shall not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of [Section 1031(f)].”

For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within [two] years of the previous transfer in a transaction otherwise qualifying under [S]ection 1031, the related party will not be entitled to nonrecognition treatment under [S]ection 1031.\(^{56}\)

In several rulings, the IRS has applied Section 1031(f)(4) to other types of multi-step transactions involving related parties.\(^{57}\)

In Rev. Rul. 2002-83, 2002 C.B. 927, the IRS formally adopted the position first enunciated in TAM 9748006. Under the facts of Rev. Rul. 2002-83, the taxpayer and the related party each owned property of equal value ($150,000). The taxpayer’s property had a 1:3 basis-to-value ratio, while the related party’s ratio was 1:1.\(^{58}\) The taxpayer transferred his property to an unrelated party through a qualified intermediary. The qualified intermediary used the exchange proceeds from that disposition to acquire the replacement property from the related party one week after the taxpayer transferred the relinquished property. The IRS ruled that:

> Under the facts [of the ruling] a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under [Section] 1031(a) . . . if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

In ruling that Section 1031(f)(4) applied to the transaction, the IRS applied the step transaction doctrine’s end result test:

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\(^{57}\) TAM 200126007; TAM 9748006.

\(^{58}\) Rev. Rul. 2002-83 does not provide what result would obtain if the related party’s basis-to-value ratio was other than 1:1. Arguably, partial gain deferral would be appropriate under the bifurcation approach discussed in footnote 62, *infra*. 

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The end result of the transaction is the same as if [the taxpayer] had exchanged property with [the related party] followed by a sale from [the related party] to [an unrelated party]. This series of transactions allows [the taxpayer] to effectively cash out of the investment . . . without the recognition of gain.

Finally, the IRS found that the taxpayer’s “exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of [Section] 1031(f) and, under [Section] 1031(f)(4), the non-recognition provisions of [Section] 1031 do not apply to the exchange between [the taxpayer] and QI.”

In all of the Section 1031(f)(4) rulings discussed above, a qualified intermediary was interposed in an attempt to avoid Section 1031(f). In each of those rulings, the IRS’s position was that the use of the intermediary was evidence that the taxpayer was attempting to circumvent Section 1031(f). Interposing an EAT in a Rev. Proc. 2000-37 related-party parking arrangement likewise could be considered evidence that the taxpayer is attempting to circumvent Section 1031(f). A transaction in which a related party sells property for cash to an EAT or other Accommodator, who, within two years after acquisition, transfers the property to the taxpayer as part of an exchange, falls squarely within the example of a Section 1031(f)(4) exchange described in the House Report. If taxpayers were allowed to avoid the related party rules by interposing an EAT, every exchange involving the fact pattern of Rev. Rul. 2002-83 would be structured in this manner. Since this would effectively eliminate Section 1031(f), interposing an EAT should not overcome Section 1031(f). However, as discussed below, a taxpayer should be able to enter into a RP Leasehold Improvements Exchange without committing the abuse Congress intended to curb through Section 1031(f).


A taxpayer may structure a RP Leasehold Improvements Exchange under Rev. Proc. 2000-37 using a long-term lease (more than 30 years) under which the related party leases real property to an EAT. The lease should give the EAT possession of the real property for more than 30 years and allow the EAT to construct improvements thereon. The lease agreement should also require the payment of fair market rents. To finance the improvements, the EAT should be able to borrow from the taxpayer, a third party lender, or a qualified intermediary (if the taxpayer has already sold its relinquished property and the qualified intermediary is holding the exchange proceeds).


60 In a RP Leasehold Improvements Exchange, there will be no merger of the lease and fee interest when the taxpayer receives the EAT’s leasehold interest upon completion of the exchange. Thus, the issues discussed at Section III C, supra, will not arise in a RP Leasehold Improvements Exchange.
This type of lease structure under Rev. Proc. 2000-37 allows the taxpayer to avoid violating the purposes of Section 1031(f)(4). If the lease is at arms-length terms, the related party arguably transfers nothing, or at most, the related party transfers a zero-value, zero-basis property. Therefore, even if entering into a lease is treated as a transfer to the EAT, there would be no basis shifting or cashing out on the transaction. Because the improvements are constructed on the land leased to the EAT and the EAT must be respected as the “tax owner” of the lease, the improvements will never be owned by the related party. Thus, the lease structure under Rev. Proc. 2000-37 allows the taxpayer to avoid violating the purposes of Section 1031(f)(4).

F. Distinction Between a RP Leasehold Improvements Exchange and EAT’s Acquisition of a Fee From Related Party for Cash

If, in lieu of the EAT leasing property from a related party in a RP Leasehold Improvements Exchange, the EAT were to purchase a fee interest from a related party for cash (and then construct improvements), the transaction may result in the type of basis shifting and cashing out prohibited by Section 1031(f). For example, assume an EAT purchases land for $100,000 from a related party as to the taxpayer, and the related party has a $100,000 basis in the land. If the taxpayer thereafter directs its qualified intermediary to purchase the replacement property from the EAT to complete its exchange, the “related party group” consisting of the taxpayer and the related party would be able to “cash out” tax free to the extent of $100,000 absent the application of Section 1031(f)(4). Accordingly, we believe an EAT’s purchase of replacement property land from a related party may cause the taxpayer’s exchange to be taxable, in whole or in part, based upon the principles of Section 1031(f)(4) and Rev. Rul. 2002-83.

G. Recommendation Regarding RP Leasehold Improvements Exchanges

Because exchanges with related parties may result in basis shifting and cashing out, such transactions must be scrutinized. If a RP Leasehold Improvements Exchange is structured properly, however, the transaction should avoid the abuse prohibited under Section 1031(f). In such situations, we believe the IRS should not challenge the

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62 Arguably, where a related party takes some cash out of a build-to-suit exchange tax-free, the taxpayer’s entire exchange should not be rendered taxable. For instance, assume in the example described in the text above that the taxpayer’s qualified intermediary received $1,000,000 in exchange proceeds and transferred $1,000,000 to the EAT to acquire (i) the land purchased from taxpayer’s related party for $100,000 and (ii) a building constructed on the land by the EAT at a cost of $900,000. Since the taxpayer will acquire $900,000 of replacement property which is untainted for purposes of Section 1031(f), the transaction could be bifurcated with the taxpayer treated as (i) selling 10% of its relinquished property for cash in a taxable transaction governed by Section 1001 and (ii) exchanging the remaining 90% of its relinquished property for the building in a transaction governed by Section 1031. Because the taxation of such a transaction has implications beyond build-to-suit exchanges under Rev. Proc. 2000-37, we believe the IRS should address this “bifurcation” issue in more general guidance under Section 1031(f) rather than in the guidance we are requesting in this report.
nonrecognition treatment of such transactions. In particular, the IRS should not challenge the nonrecognition treatment of RP Leasehold Improvements Exchanges that involve a Related Party leasing property to the EAT. Since there is no transfer of property (or, alternatively, a transfer of a zero-basis, zero-value property) by the related party to the EAT and no tax-free cashing out, a RP Leasehold Improvements Exchange presents no possibility for abuse.

Appendix A

This Appendix describes the steps in a typical Leasehold (or RP Leasehold) Improvements Exchange under Rev. Proc. 2000-37 (the “Exchange”). It is assumed that the Exchange will involve one relinquished property and one replacement property (i.e., the property “parked” with the EAT, including improvements constructed by the EAT while it held “qualified indicia of ownership”)

**Step One:** The Taxpayer and the EAT will enter into a “qualified exchange accommodation arrangement” (the “QEAA”) pursuant to the safe harbor under Rev. Proc. 2000-37. To commence the QEAA, Taxpayer and the EAT will execute a Qualified Exchange Accommodation Agreement (the “QEA Agreement”) pursuant to which Taxpayer will direct the EAT (i) to acquire a greater-than-30-year leasehold interest (the "Leasehold Interest") in certain land (the “Land”) identified by the Taxpayer and owned either by the Taxpayer (in a Leasehold Improvements Exchange) or a Related Party (in a RP Leasehold Improvements Exchange) and (ii) to construct on the Land certain leasehold improvements, also identified by the Taxpayer (the "Leasehold Improvements"). Under the terms of the QEA Agreement, the EAT will be obligated to transfer the Leasehold Interest and the Leasehold Improvements to the Taxpayer on or before the 180th day after the day the EAT acquires its Leasehold Interest (the “QEAA Termination Date”) for a purchase price equal to the cost of constructing the Leasehold
Improvements (the “EAT’s Construction Costs”). The QEA Agreement will further provide for the Taxpayer (or an affiliate) to loan money to the EAT in order to finance the EAT’s Construction Costs (the “Taxpayer Loan”).

**Step Two:** Pursuant to an Exchange Agreement between a Qualified Intermediary (or “QI”) and the Taxpayer (the "QI Exchange Agreement"), and consistent with the “safe harbor” for deferred exchanges with a QI under Treasury Regulation §1.1031(k)-1(g)(4)(the “QI Safe Harbor”), the Intermediary will agree to (i) acquire an interest in certain relinquished real property (the "Relinquished Property") owned by the Taxpayer by accepting an assignment of a Purchase and Sale Agreement between the Taxpayer and a third-party buyer (the “Transferee”); (ii) transfer (or cause the Taxpayer to transfer) the Relinquished Property to the Transferee and receive from the Transferee the net cash purchase price for the Relinquished Property (the “Exchange Proceeds”); and (iii) hold the Exchange Proceeds in order to acquire the replacement property identified by the Taxpayer.

**Step Three:** Pursuant to the terms of the QI Exchange Agreement, the Taxpayer will identify the Leasehold Interest and the Leasehold Improvements as Replacement Property for its Exchange. The Taxpayer will then assign to the QI its right under the QEA Agreement to acquire the Leasehold Interest and the Leasehold Improvements from the EAT. To complete the Exchange, the QI will direct the EAT to transfer the Leasehold Interest and the Leasehold Improvements to the Taxpayer on or before the QEAA Termination Date.

63 Alternative, the EAT may obtain a construction loan from a bank or other third-party lender, typically with a guaranty by the Taxpayer.

64 It is assumed that at the time of transfer from the EAT to the Taxpayer the Leasehold Improvements...
equal to the EAT’s Construction Costs as consideration for such transfer using the Exchange Proceeds plus, if necessary, additional amounts provided by the Taxpayer. The EAT, in turn, will use the funds received from the QI to repay the Taxpayer Loan.

In a Leasehold Improvements Exchange, the EAT will construct Leasehold Improvements on Land that the Taxpayer presently owns in fee, and will continue to own in fee, during the term of the QEA Agreement. The lease between the Taxpayer and the EAT (the "Lease") will provide for the lessee to hold legal title to the Leasehold Improvements during the term of the Lease. The EAT will enter into, or accept assignments of, various construction contracts required to construct the Leasehold Improvements and make all required payments to the contractors through draws under the Taxpayer Loan; however, the Taxpayer will establish the specifications for the Leasehold Improvements and will supervise the construction, typically through a Construction Management Agreement between the EAT and the Taxpayer or an affiliate of the Taxpayer. A RP Leasehold Improvements Exchange would follow the same format except that the EAT would lease the Land from a Related Party.

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either will be completed or, if they are not completed, will constitute real property under local law.

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