Improvements on Property Already Owned

1031 Knowledge

MAKING IMPROVEMENTS ON PROPERTY ALREADY OWNED BY AN AFFILIATE OR PARTY RELATED TO THE TAXPAYER

In a typical improvement exchange, a taxpayer uses a Qualified Intermediary (QI) to sell a relinquished property. An affiliate of the QI, referred to as an Exchange Accommodation Titleholder (EAT), uses the proceeds from the relinquished property sale to purchase a replacement property from a third-party seller, improve the replacement property, and transfer improved property to the taxpayer within 180 days after the day the relinquished property was transferred.

The use of the EAT and QI, in this manner, allows the taxpayer to control the property and improvements built thereon. Because the EAT is treated as owning the property for federal income tax purposes; however, the taxpayer is able to reinvest the proceeds from the sale of the relinquished property in the land and improvements on a tax-deferred basis pursuant to IRC Section 1031. This creates greater tax deferral for the taxpayer because instead of having taxable boot for a reduction in debt or proceeds not reinvested, they can reinvest more equity into the replacement property in the form of real property improvements.

It is well established that a taxpayer cannot include improvements to property already owned as replacement property. However, the IRS released Private Letter Rulings 200251008 and 200329021, which set forth structures whereby an EAT made improvements to a property owned by an affiliate or related party and then the taxpayer received the improved property as qualifying replacement property. Although these rulings do not have identical circumstances, they do share a similar approach:

1. Taxpayer enters into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT and enters into an exchange agreement with a QI;
2. Taxpayer's affiliate or related party leases the replacement property to EAT at fair market rent, for a term of not less than 30 years, as part of the QEAA as defined in Revenue Procedure 2000-37;
3. Taxpayer (or a third-party bank where the taxpayer gives its personal guaranty) lends EAT the funds needed to construct improvements on the leased property;
4. Taxpayer assigns its rights to the sale contract of the relinquished property to the QI;
5. Taxpayer assigns its rights in the QEAA to the QI;
7. QI uses proceeds from the sale of the relinquished property to pay EAT;
8. EAT uses the proceeds received from the QI to pay for improvements and/or to pay the construction loan in full; and
9. QI directs EAT to transfer the improved replacement property directly to the taxpayer.

Note: API urges every taxpayer to consult with their own legal and/or tax advisors regarding their specific situation. A PLR applies to the facts and circumstances of a taxpayer's specific situation. Most PLRs have language as follows: "This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent."

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