A New Private Letter Ruling Suggests A Method for Handling Certain Construction Exchanges

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A “Construction Exchange” is a special type of tax-deferred IRC Sec. 1031 like-kind exchange that allows a taxpayer to defer recognizing income by sheltering proceeds from the sale of relinquished property into improvements made to replacement property, not just in the cost of buying the replacement property (as in an ordinary “forward exchange”). In order for a construction exchange to work, the taxpayer cannot own the property at the time the improvements are made. In a typical safe-harbor construction exchange [Rev. Proc. 2000-37], the replacement property is purchased from a third-party seller on behalf of the taxpayer by an exchange accommodation titleholder ("EAT"). The EAT is essentially acting as the taxpayer’s agent under a contract that allows the taxpayer to use and improve the replacement property during the taxpayer's 180-day exchange period. By the end of the exchange period, the EAT transfers legal ownership of the replacement property to the taxpayer, which completes the exchange.

One common problem is that a safe-harbor construction exchange will not work if the taxpayer owned the replacement property within 180 days of the start of the exchange. [Rev. Proc. 2004-51.] What if the replacement property is owned by a related party, such as a multi-member LLC that the taxpayer controls? There has been some concern that such an exchange might fail to qualify as a safe-harbor construction exchange because ownership of the replacement property by the related party would be viewed by the IRS as the equivalent of ownership by the taxpayer himself/herself.

IRS Private Letter Ruling 201408019, issued February 21, 2014, indicates that this is not a problem. In that case, the IRS approved a transaction in which the related party holds a long-term lease on the replacement property. That property will be subleased to an EAT which will hold the property during the exchange period while the taxpayer improves it. At the end of the exchange, the sublease will be assigned to the taxpayer. Both the related party and the taxpayer promise to hold on to their respective real property interests for not less than two years after the exchange. (See IRC Sec. 1031(f).) The letter ruling noted that the improvements to the property would have a shorter useful life than the length of the lease.

This is interesting because IRC Sec. 109 provides that improvements to real property by a tenant are not usually considered as income to the landlord at the end of a lease. Presumably, the IRS was concerned in this case that the construction exchange should not be used as a device to transfer improvements from the taxpayer to the related party.

IRC Sec. 1031(f) requires that both the taxpayer and a related party hold onto their respective properties for a minimum of two years when they exchange, even if the exchange is indirect. Therefore, it is usually preferable in this kind of transaction for the replacement property to be rented, not sold, to the taxpayer, so that the related party isn't giving up any interest in the real property. However, that means that the taxpayer is not sheltering any proceeds in the value of the real estate itself. Fair market rent should be charged and should not be paid in advance, and the period of the lease should be not less than 30 years.