The Build-To-Suit Exchange

The build-to-suit exchange, also referred to as a construction or improvement exchange, gives the Exchanger the opportunity to use all or part of the exchange funds for construction of the replacement property and still accomplish a tax deferred exchange. This is a variation of the delayed or reverse exchange that allows the Exchanger more flexibility and provides the Exchanger with the opportunity to either renovate an existing improved property or even construct a new improvement on raw land. In the most common type of build-to-suit exchange the Exchanger sells the relinquished property in a delayed exchange and then acquires the replacement property after it has been improved with the exchange funds from the relinquished property. It is important to note that any improvements made to the replacement property after the Exchanger takes title are considered to be "goods and services". These goods and services are not considered "like-kind" property and are taxable as boot as are any remaining exchange funds. Treasury Regulations §1.1031(k)-1(e). Consequently, to be included in the exchange any improvements to the property must occur before the Exchanger takes title. *Bloomington Coca Cola Bottling Co. v. Commissioner,* 189 F.2d 14 (CA7 1951).

If the Exchanger wishes to include construction on the replacement property as part of the exchange, one option is to contract with the seller to have the construction completed by the seller or a contractor before the transaction closes and the Exchanger takes title to the property. Escrow holdback accounts do not work for build-to-suit exchanges. Another option for the Exchanger is to negotiate with a builder to purchase the replacement property for the purpose of completing the construction, and then when the replacement property is finished the Exchanger can sell the relinquished property in an exchange and buy the improved property from the builder to complete the exchange. If neither of these options will work, or when the Exchanger desires to structure the transaction under the "safe harbor" guidelines of Revenue Procedure 2000-37 ("Rev. Proc. 2000-37") as discussed below, the build-to-suit exchange is accomplished by using an Exchange Accommodation Titleholder to hold title to the Exchanger's replacement property pending the completion of the improvements. In all cases it is important to remember that all applicable rules of IRC §1031 apply equally to build-to-suit exchanges, such that the Exchanger has 45 days to properly identify the replacement property, and no more than 180 days to acquire the identified improved replacement property. Also, to have a totally tax deferred exchange, the Exchanger must ultimately acquire replacement property that is of the same or greater value as the relinquished property, and use all of the exchange equity in the acquisition price of the replacement property and the construction of the improvements.

Until recently it had been unclear whether the validity and nonrecognition status of the build-to-suit exchange would be upheld by the IRS if the replacement property that was to be improved was acquired by either the Qualified Intermediary or an entity created by the Qualified Intermediary to park the property pending the construction of the improvements. However, that question was answered by the IRS in the form of Rev. Proc. 2000-37, which provides that nonrecognition treatment on exchanges in which either the replacement property or relinquished property is parked with an exchange accommodation titleholder pursuant to the terms of the Revenue Procedure will be recognized if the transaction falls within the scope of this announced IRC § 1031 "safe harbor."

The "Safe Harbor" Build-To-Suit Exchange

In an exchange structured as a build-to-suit exchange under the safe harbor protection of Rev. Proc. 2000-37 the entity used to facilitate a build-to-suit exchange is referred to as the Exchange Accommodation Titleholder ("EAT"), and the replacement property held by the EAT is commonly called the "parked property". The EAT will generally form a disregarded special purpose entity (the "Holding Entity") to take title to the parked property. The document governing the relationship between the Exchanger, EAT and the Holding Entity is termed the "Qualified Exchange Accommodation Agreement" ("QEAA").

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The Build-To-Suit Exchange *(Continued)*

Under Rev. Proc. 2000-37, just as in the delayed exchange requirements, a build-to-suit exchange must be completed within 180 days after either the day the Exchanger closes on the sale of the relinquished property or the day the Holding Entity acquires the parked property whichever first occurs. The durational limit on delayed build-to-suit exchanges is taken from those of a delayed exchange, which by statute must be completed within the lesser of 180 days or the due date of the Exchanger's tax return for the year in which the relinquished property is transferred. Although the Holding Entity is on title, the Exchanger must still properly identify the replacement property and any improvements to be completed on the property within 45 days following the sale of the relinquished property. The identification rules require written identification of the replacement property, including any improvements to be made to the replacement property, to be delivered to another party to the exchange, such as the Qualified Intermediary or the Holding Entity, and limits the number of alternative and multiple replacement properties that can be identified. If the built-to-suit exchange is conducted as a reverse build-to-suit, the relinquished property identification rules of Rev. Proc. 2000-37 will also apply.

The Procedure

As in a typical delayed exchange, the delayed build-to-suit exchange begins when the Exchanger sells the relinquished property. Prior to closing on the purchase of the replacement property, the Exchanger will enter into the QEAA with the EAT and the Holding Entity and will assign the rights in the purchase contract to the Holding Entity. The Qualified Intermediary and the Holding Entity will enter into an agreement that will allow the Holding Entity to use the exchange funds to acquire a fee or fee-equivalent interest in the replacement property and to complete the identified improvements. On behalf of the Holding Entity, the Exchanger arranges for the construction to be completed on the replacement property. The Exchanger, or its designated representative, is retained by the Holding Entity to act as its project manager overseeing all aspects of the construction on behalf of the Holding Entity. During the 180-day exchange period, the Exchanger, as Project Manager, sends construction invoices to the Holding Entity for payment. Build-to-suit exchanges are less complicated when the Exchanger can pay all cash for the improvements that are to be made to the replacement property. If a construction loan from an institutional lender is required, the Exchanger should seek lender approval for this type of exchange prior to beginning the exchange since the Holding Entity may be required to be the borrower on the loan as the titleholder of the property. To protect the Holding Entity from liability in the event of a default by the Exchanger, the Holding Entity will only be the borrower on a non-recourse loan and deed of trust or mortgage. On the earlier of the end of the 180-day exchange period or the completion of the construction on the replacement property the terms of the QEAA are satisfied and the Holding Entity will then transfer the replacement property to the Exchanger to complete the exchange. Sometimes, depending on the circumstances and other factors relevant to the Exchanger's transaction, instead of transferring the replacement property to the Exchanger via a deed from the Holding Entity, the EAT will transfer the replacement property to the Exchanger by assigning the sole membership interest in the Holding Entity to the Exchanger. Selecting the appropriate method to transfer title should be determined by the Exchanger after consulting with their tax advisor. If a third party lender is involved the Exchanger will assume the construction loan upon the conclusion of the exchange. Any construction to be included in the exchange must be built and paid for prior to the Holding Entity's transfer of the replacement property to the Exchanger.

In the light of Rev. Proc. 2000-37, it is not necessary that the Exchanger close on the sale of the relinquished property prior to the closing of the replacement property. In a reverse build-to-suit exchange the relinquished property does not close until sometime after the Holding Entity has acquired the replacement property and improvements are either underway or are completed. In reverse build-to-suit exchanges since the relinquished property has not yet sold the Exchanger or a third-party lender must make funds available to the Holding Entity to acquire and improve the replacement property, otherwise the procedure is the same as discussed in this Brief Exchange.

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The Build-To-Suit Exchange *(Continued)*

Important Issues

To have a valid exchange the Exchanger must properly identify the replacement property to be acquired within the 45-day identification period. In a delayed build-to-suit exchange the replacement property does not exist in the form that it is to be later acquired and so the property identification rules for property "to be constructed" are satisfied by the Exchanger "if a legal description is provided for the underlying land and as much detail is provided regarding the construction of the improvements as is practicable at the time identification is made." Treasury Regulations §1.1031(k)-1(e)(2).

- For new construction on bare land the identification requires a specific description of the land (legal description or tax lot) and a drawing or detailed summary of the new construction to be done to the land.
- Where the replacement property is an existing structure in need of remodeling, an address of the building and a summary of the remodeling project will probably suffice.
- For purposes of the 200% rule, the fair market value of the identified property is the estimated fair market value of the improved property at the time the Exchanger expects to receive it.

The exchange requirement that the Exchanger take title to the replacement property within the 180-day exchange period applies to delayed build-to-suit exchanges. If the improvement exchange is structured as a "reverse" exchange, the Exchanger must acquire the replacement property within 180-days following the date the Holding Entity took title. After the Exchanger takes title to the replacement property construction may continue but the value of the additional construction will not be considered as part of the exchange. The improved replacement property eventually received by the Exchanger to complete the exchange must be "substantially the same property as identified." Normal "course of construction" changes may meet this test, however, "substantial changes" to the construction of the improvements probably do not meet this test. Treasury Regulations §1.1031(k)-1(e)(3). The Exchanger should keep in mind the following:

- For real property there is no requirement that construction be completed within 180 days when the Exchanger receives the replacement property, which means often that the improvement does not need to be suitable for occupancy or use. The Exchanger will be credited with receiving replacement property valued as of the date it is transferred to the Exchanger provided the improvements in place on that date are considered real property in the state in which the replacement property is located. For most exchanges, that value of the replacement property is comprised of the amount of the completed construction contract and the value of the land.
- The tax rules specifically prohibit the inclusion in the exchange value of a prepaid, but not completed, construction contract for materials since these delivered materials are considered prepaid services, which are not "like-kind" to real property.

Practical Considerations

Build-to-suit exchanges are definitely more complex than the more typical delayed exchange and require that the Exchanger plan the exchange carefully before either (1) selling the relinquished property or (2) having the Holding Entity acquire the replacement property and starting the strict delayed or "safe harbor" exchange deadlines. The Exchanger should always consider the following issues:

- In delayed build-to-suit exchanges, since the exchange period is limited to 180 days, which is often too short for many types of construction, it is critical that the build-to-suit exchange be well planned so that the purchase of the replacement property and the construction can begin shortly after the close of the relinquished property.

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The Build-To-Suit Exchange *(Continued)*

- If a construction loan is required for the build-to-suit exchange, the Exchanger should consult with the lender prior to beginning the exchange to resolve and eliminate any problems the lender may have in making the construction loan to the Holding Entity. The lender will usually require the Holding Entity to sign the promissory note and the Deed of Trust or Mortgage to protect the lender's security interest while the Holding Entity holds title. All loan documents to which the Holding Entity is a party must be non-recourse to the Holding Entity.
- During the time the Holding Entity is on title to the parked property and while the contractor completes the construction the Holding Entity will require hazard and commercial general liability insurance, an acceptable recent Phase I Environmental Assessment Report and an indemnity from the Exchanger from any liability.
- Despite the provisions of Rev. Proc. 2000-37, there may be additional state, county, or local transfer taxes that may be assessed twice: (1) when the replacement property is deeded from the seller to the Holding Entity to hold while the construction is completed and (2) when the improved replacement property is deeded to the Exchanger to complete the exchange. In a recent Private Letter Ruling (PLR 200148042), the IRS held that the use of language in the QEAA stating that the Holding Entity is the agent of the Exchanger for the purpose of avoiding transfer taxes would not invalidate the safe harbor. Unfortunately, not all states and municipalities recognize an agent/principal transfer tax exemption and, therefore, the Exchanger should be aware that double transfer taxes may be an additional cost of the transaction in those jurisdictions. Also, the accounting, legal and Qualified Intermediary and/or Holding Entity fees will almost certainly be significantly higher than on simultaneous or delayed exchanges where the deeding is direct and the Qualified Intermediary is not required to hold title to property.
- Based on current legal authority, an Exchanger may not do a build-to-suit exchange where the construction to take place is on land owned by the Exchanger. *DeCleene v. Commissioner*, 115 T.C. No. 34 (2000) and *Bloomington Coca Cola Bottling Co. v. Commissioner*, 189 F.2nd 14 (CA7 1951). Creative practitioners had attempted to avoid this negative authority by structuring the build-to-suit exchange as construction on a newly created, long-term leasehold interest granted to the Holding Entity. The Holding Entity would construct improvements on the leasehold interest and then transfer the improved leasehold to the Exchanger to complete the exchange. Recently, however, Rev. Proc. 2000-37 was modified by Revenue Procedure 2004-51 to provide that the "safe harbor" of Rev. Proc. 2000-37 "does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of ownership of the property to an exchange accommodation titleholder" (Revenue Procedure 2004-51 Section 4). Although opinions are split as to whether the technical language of Rev. Proc. 2004-51 directly impacts the newly created leasehold structure, verbal indications from the IRS indicate that this new modification was intended to take transaction structures in which the improvements are constructed on newly created leasehold interests outside of the safe harbor when the Exchanger is the lessor under the newly created lease.
- There are, however, several Private Letter Rulings (200251008 and 200329021) that appear to reach a different conclusion when an affiliate or related party, as opposed to the Exchanger itself, owns the land on which the improvements are to be constructed. Taxpayers should be cautioned that in Rev. Proc. 2004-51 the IRS announced that "[t]he Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate."

Build-to-suit exchanges can be a creative way to structure an exchange to best fit the Exchanger's investment goals. However, it is essential that Exchangers seek adequate legal and tax counsel in planning a build-to-suit exchange prior to entering into the exchange.

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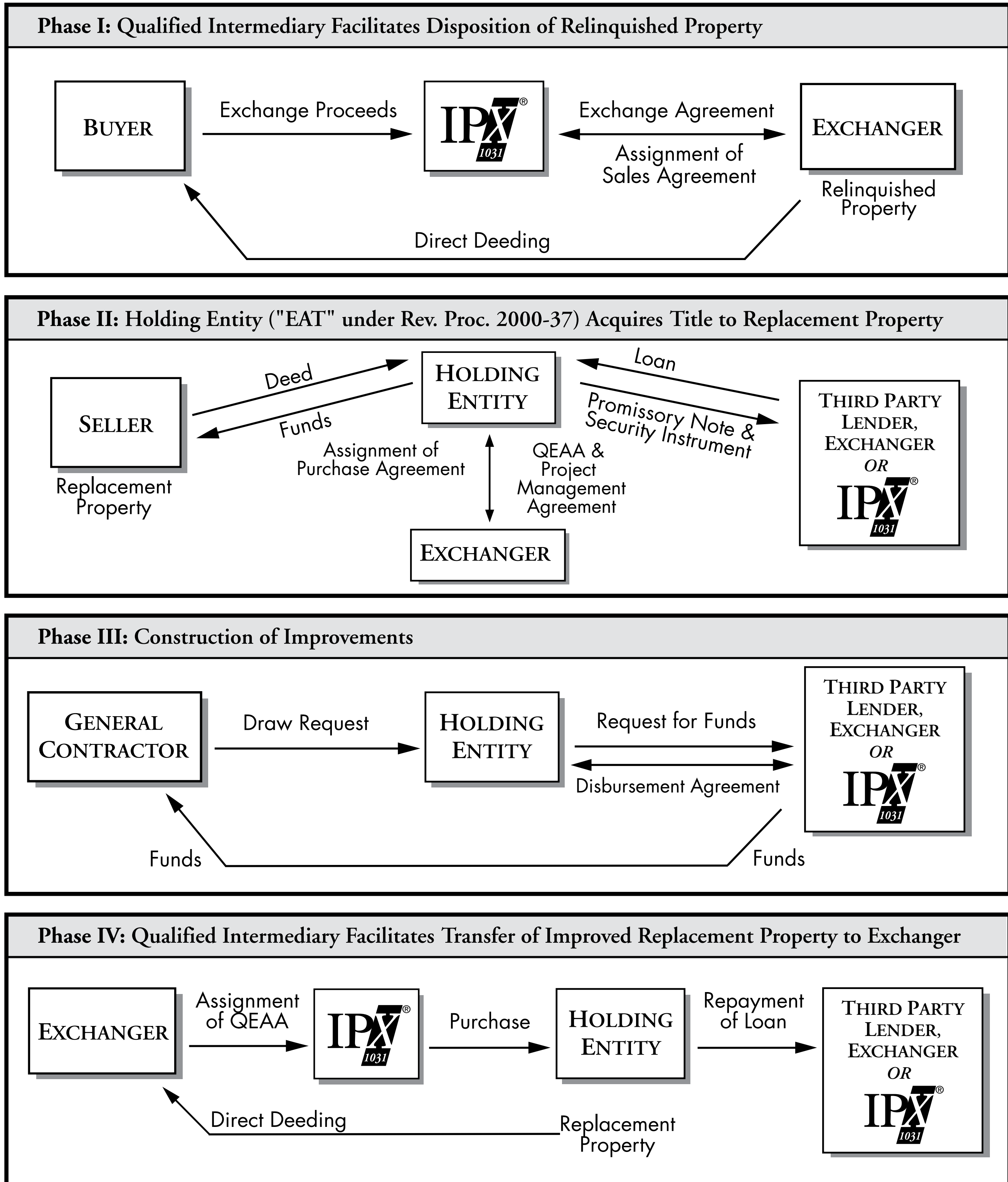
"Delayed Build-To-Suit" Exchange



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