

## Investment Analysis

# Navigating the Maze

Developers can use these strategies to benefit from 1031 exchanges.

By Ricky B. Novak, JD

**T**he labyrinth of rules that taxpayers must follow when completing Internal Revenue Code Section 1031 exchanges can be overwhelming. Commercial real estate developers often prefer to avoid this maze, thinking that most of their work involves non-qualified inventory. However, this common misconception has caused many developers to miss out on the sophisticated exchange techniques that could help them convert nonqualified inventory into qualified property — and significantly minimize their tax liability.

The critical hurdle that developers must clear in 1031 exchanges is establishing the held-for-investment intent for the properties they are relinquishing and acquiring. To meet this requirement, a developer's intent of ownership must be considered. Although the Internal Revenue Service never has specified a minimum time period a taxpayer must hold a property to qualify for exchange treatment, one tax year is the guideline most tax professionals follow.

In addition, a developer's actions must establish the investment intent. During the period of time the developer owns the property, he should re-frain from actions that are inconsistent with the investment intent. Specifically, the developer should avoid any marketing activities while owning the property, such as formally listing the property with a real estate broker or agent, erecting for-sale signage on the property, listing the property online, or any other activities consistent with a sales intent.

During the investment's holding period, developers also must avoid improving the property as this activity may change the tax category from investment property to nonqualified inventory. The developer can embark upon the rezoning process while holding the land without compromising the investment intent. However, the developer should not physically begin construction during the holding period. There is no rule specifying exactly how much development disqualifies a property from exchange use. However, if the developer actually constructs improvements, the resulting commercial property still could continue to support the investment intent if the developer were to lease the property.

Each year, taxpayers are given an opportunity to tell their stories to the IRS through the tax return filing process. Property that is held for investment can and should be reported in a manner that is distinct from the developer's inventory property. This may require the property to be held in a separate legal entity or in the developer's personal name.

When contemplating a tax-deferred exchange, it is important to remember that exchanges are property specific, not person specific. Although historical activity and transaction volume are considered, the treatment of the property to be exchanged is much more critical.

Following these prescribed guidelines should establish that a property qualifies for an exchange. The two exchange scenarios below illustrate these tax strategies.

### **Utilizing a Holding Company**

Many developers purchase property prior to obtaining the desired zoning or land disturbance permits from the governing authorities. This arduous process can take months, or in some jurisdictions, years to complete. Developers who typically purchase land prior to final zoning approval easily can implement a 1031 strategy.

For example, Development Co. creates a new holding company, Investment Co., to take title to the to-be-developed property. Investment Co. is an unrelated party to Development Co., which means that Development Co. owns no more than 50 percent of the entity. Investment Co. or Development Co. can be responsible for rezoning the property and obtaining LDPs. Investment Co. owns the property as an investment and does not physically perform any development or marketing activities.

Once zoning and LDPs have been obtained and the developer is ready to begin construction, Investment Co. initiates a 1031 exchange by selling the undeveloped land to Development Co. The price at which the land is sold should reflect both the fair-market property appreciation during the period of time that Investment Co. held it, as well as the increase in value derived from the new zoning and LDPs. Such an increase in value is left to the developer's reasonable discretion, but must be within market value.

To initiate the exchange, Development Co. acquires the undeveloped property from Investment Co. The sale proceeds then are forwarded to a qualified intermediary to initiate the exchange, and Investment Co. identifies and acquires additional property to complete the exchange.

The benefit of this structure is that the sale of the unimproved property from Investment Co. to Development Co. effectively converts what otherwise would be ordinary income from the sale of inventory into long-term capital gains, which are then deferred via the 1031 exchange. When Development Co. sells the inventory to a third-party purchaser, it does so at a higher basis and effectively reduces the amount of ordinary income.

### **Building Improvements**

Developers often acquire raw land with a plan to develop the property once the area is ready to absorb the project or the build-to-suit tenant is ready to move forward. Or, in the case of a large office or industrial project, a developer may be retained to build the entire property in a multiphase timeframe. It may intrigue developers to know that they can build improvements on property that they already own and use these improvements as replacement property in exchanges.

The IRS first provided guidance on this in Revenue Procedure 2000-37 and later supplemented it with Rev. Proc. 2004-51. In the latter guidance, the IRS stated it was concerned about having the same taxpayer own both the relinquished property and the ground that was to be improved. The IRS noted, however, that these taxpayers could be related parties. In other words, the developer could own the relinquished property in his individual name and own the property on which he wished to build in an entity he controls. Additionally, the guidelines noted that the taxpayer could cure the "same taxpayer" issue by simply transferring the to-be-built-upon property to a related or unrelated party at least 180 days prior to initiating the exchange.

In this scenario, the developer/exchanger retains a QI to assist in the sale of the relinquished property, but utilizes an accommodation titleholder and enters into a 30-year or longer ground lease with the owner. The AT entity typically is owned by a holding company that is set up by the QI. During the 180-day exchange period, the AT subleases the property back to the developer and hires the developer as the construction manager, thus granting construction oversight responsibility to the developer.

At the earlier of 180 days or the completion of the construction improvements, the exchange is completed when the AT transfers the leasehold improvements to the taxpayer. Additionally, the lease arrangement should be respected for a minimum of two years.