

Establishing a deferral plan

Real estate developers should consider these strategies to accrue the benefits from 1031 exchanges

The myriad rules taxpayers must follow when completing 1031 exchanges can be overwhelming. Real estate developers often prefer to avoid this complex analysis, thinking most of their work involves nonqualified 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 IRS has not specified a minimum time period a taxpayer must hold a property to qualify for exchange treatment, one year is the general guideline that most tax professionals follow. A more aggressive tax professional may assert that a one-year holding period is not a "bright line" test requirement, and a taxpayer should merely seek to straddle a tax year. Conversely, a more conservative tax adviser may argue that two years is an appropriate holding period and records should be evident to demonstrate the asset was held for investment.

In addition to holding period concerns, a developer's actions must establish the requisite investment intent. During the time the developer owns the property, they should refrain 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 may want to avoid improving the property, as this activity may change the tax category from investment property to nonqualified inventory. A facts-and-circumstances analysis of such activities should always be conducted when considering this strategy in order to better understand which actions could be detrimental. The developer could embark on the rezoning process while holding the property 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, resulting commercial property could still continue to support the investment intent if the developer were to lease the property to an unrelated party.

Each year, taxpayers are given an opportunity to convey to the IRS through the tax return filing process how a given property is held. 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, although holding real estate in one's personal name comes with its own set of legal liability concerns.

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.

USING 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. Generally, developers who typically purchase land prior to final zoning approval can easily implement a 1031 strategy.

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

Once zoning and permit approvals have been obtained and the developer is ready to begin construction (again keeping in mind both the holding period and the investment intent actions of Investment Co. during the holding period), Investment Co. initiates a 1031 exchange by selling the undeveloped land to Development Co.



The price at which the land is sold should reflect 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 permit approvals. Such an increase in value must be supported and within market.

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 a portion of 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.

There are numerous variations to the above scenario. For example, a developer may complete all of the horizontal improvements on the land, subdivide it into phases and — while performing vertical improvements on Phase I or marketing Phase I outparcels for sale — hold Phases II and III in the separate Investment Co. for longer-term appreciation as an investment. This approach generally allows the developer to exchange Phases II or III at a point in the future. As always, a

facts-and-circumstances analysis and careful planning are critically important.

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. In the case of a large office or industrial project, a developer may be retained to build the entire property in phases over time. It may intrigue developers to know they can build improvements on property they already own and use these improvements as replacement property in exchanges.

The IRS first provided guidance on this in Revenue Procedure 2000-37, later supplementing it with additional guidance, in 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 to be improved. The IRS noted, however, these taxpayers could be related parties. In other words, the developer could own the relinquished property in his individual name or in a partnership and own the property on which he wished to build in a separate LLC he controls. In addition, the guidelines noted the taxpayer could cure the “same taxpayer” issue (i.e., a situation where the exact same taxpayer owns both the property to be relinquished and the property to be built upon) 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 qualified intermediary to assist in the sale of the relinquished property but uses an accommodating titleholder to enter a 30-year or longer ground lease with the owner. The accommodating titleholder entity typically is owned by a holding company that is set up by the qualified intermediary. During the 180-day exchange period, the accommodating titleholder 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 and the accommodating titleholder transfers the leasehold improvements to the taxpayer. In addition, the lease arrangement should be respected for a minimum of two years.

CONCLUSION

Prudent real estate developers willing to consider complex strategies may find themselves rewarded by mitigating tax liability associated with their activities. By promoting active communication between their tax advisers, legal advisers, land acquisitions and development operations teams and their qualified intermediary, developers can appropriately structure real estate transactions to avoid the pitfalls sometimes associated with 1031 exchanges. ■

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