

The Delayed Improvement Exchange on Ground Lease – Structure



Although Revenue Procedure 2000-37 (Rev. Proc. 2000-37) is usually associated with Reverse Exchanges, all parking arrangements can benefit from the safe harbor provisions. In addition to the Exchange Agreement with IPX1031 as the Qualified Intermediary, Delayed Improvement Exchanges involve the use of a Qualified Exchange Accommodation Agreement (QEAA) and an Exchange Accommodation Titleholder (EAT). In situations where the Replacement Property is a leasehold interest, the EAT will form a special purpose entity (SPE) to acquire and hold the ground lease interest.

Phase I: Qualified Intermediary Facilitates Transfer of Relinquished Property:

The exchange begins with IPX1031 entering into an Exchange Agreement with the Exchanger in which IPX1031 agrees to acquire the Relinquished Property and transfer it to the buyer. The proceeds from the sale are deposited into the Exchange Account, then used to acquire the Replacement Property from the seller. Ultimately, the property will be transferred to the Exchanger to complete the exchange. The Exchange Agreement provides that if improvements are to be constructed on the Replacement Property prior to its acquisition by the Exchanger, an affiliate of IPX1031 will acquire and hold title to the property during the construction period.

The acquisition of the Replacement Property may occur simultaneously with sale of the Relinquished Property or thereafter. Pursuant to the IRS regulations, the Exchanger must not only identify the Replacement Property, but the improvements as well. The intended improvements should be identified with as much detail as is practicable. The identification should also include the legal description of the underlying land. The identification must be made within 45 days of the transfer of the Relinquished Property.

Phase II: SPE Acquires Newly Created Leasehold Interest:

The SPE becomes the lessee under a newly created ground lease. The ground lease must have a term in excess of 30 years to qualify the leasehold interest as a like-kind to real estate. The Replacement Property will be the leasehold interest, plus the improvements that will be added during the period the SPE is the lessee.

The SPE and the EAT will enter into a Qualified Exchange Accommodation Agreement (QEAA) with the Exchanger under which the SPE agrees to hold the Replacement Property for a period of time not to exceed 180 days following the transfer of the Relinquished Property. The SPE may also sublease the Replacement Property to Exchanger.

Phase III: Construction of Improvements:

The SPE will engage the Exchanger as the Project Manager to oversee the construction activities on the Replacement Property. Although the Project Management Agreement gives the Exchanger broad powers when dealing with the improvements, including contracting with the contractors and consultants involved in the improvements process, any documents requiring the approval or signature of the legal owner of the Replacement Property must be delivered to the SPE, as the legal owner, for execution.

The Exchanger, as Project Manager, will present draw requests to the SPE. The SPE will fund those draws with funds advanced by IPX1031 under the QEAA or borrowed the Exchanger or a third-party construction loan.

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Phase IV: Qualified Intermediary Facilitates Transfer of Improved Replacement Property to Exchanger:

When the improvements are complete or on the 180th day after the Relinquished Property was closed, whichever occurs first, IPX1031 will facilitate a transfer of the Replacement Property from the EAT to the Exchanger. This off title transfer can be accomplished by the EAT causing the SPE to assign the ground lease to Exchanger, or by the EAT assigning its membership interest in SPE to Exchanger.

There is no requirement that the improvements be completed at the time the Replacement Property is transferred to the Exchanger, however, the value of the leasehold plus the improvements at the time of the transfer must be sufficient to successfully complete the exchange (i.e. even or up in value from that of the Relinquished Property). In addition, any debt from the Relinquished Property must be replaced and all proceeds from the sale of the Relinquished Property must be spent. Pre-payments to contractors will not qualify for exchange treatment. Such payments are for goods and services, which are not like kind to real property. The Exchanger must refer to state law to determine if materials not yet incorporated or affixed in the property will be considered real property. In most states building materials which are not actually in place will not be considered real property.

It is well settled that a long-term leasehold, plus improvements, qualifies as Replacement Property in an exchange when the underlying land is owned by a party unrelated to the Exchanger. Recent rulings have even approved exchanges where the underlying land is owned by a related party. However, some taxpayers seek to use exchange funds to improve a leasehold on land already owned by the taxpayer. Although such exchange structures have been consistently disallowed by the IRS, some taxpayers insist on proceeding anyway. Such a structure is very aggressive. It is critical that that taxpayer's intent on using exchange funds to improve land they already own discuss their proposed transaction with a tax and/or legal advisor before proceeding. IPX1031 is available to discuss the pros and cons with the taxpayer and their advisors. Please refer to Brief Exchange: The Safe Harbor Reverse Exchange for further detail and flow charts.