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Tax Watch

Leasehold Interests Offer Alternative 1031 Exchange Options

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Typical Internal Revenue Code Section 1031 exchanges involve the sale of real estate and the acquisition of like-kind replacement property. Basically, property held for investment is like-kind with any other property held for investment.

Fee-title investment real estate is the most common property type exchanged, but other ownership interests may be used as well. Specifically, leasehold interests can be used in exchange transactions, but different rules apply to each situation. While not as common as fee-title transfers of real property, leasehold interest exchanges can be a great benefit to clients when used in the appropriate circumstances and under expert tax guidance.

Long-Term Interests

In some instances, fee-title real estate can be exchanged for leasehold interests. Internal Revenue Service regulations state that a leasehold interest of 30 years or longer is like-kind with fee-title real estate. Subsequent rulings provide that option renewal periods are included in determining the leasehold interest length; thus, if the lease has a 20-year initial term and three five-year options, the length of the lease is 35 years for 1031 exchange purposes.

For example, to avoid incurring taxable gain Dan Smith wants to use an exchange to sell a $750,000 office building and purchase an existing lease on a hunting lodge and 800 acres of land for $850,000. The 25-year lease has two 10-year extensions. Therefore, the leasehold length is 45 years (25 years plus two 10-year extensions). In compliance with IRS guidelines, Smith can sell the office building and buy the 45-year leasehold interest as replacement property to complete a successful exchange.

Short-Term Interests

Although leasehold interests of 30 years or less are not like-kind with fee-title real estate, they may be considered like-kind with other short-term leasehold interests. In one private letter ruling, the IRS allowed the owner of a 23-year motel property leasehold interest to exchange it for a golf course leasehold interest that had an unspecified term of less than 30 years.

For instance, Fine Department Store has five years remaining on its current lease but wants to move to a better location in a nearby mall. Using a qualified intermediary, Fine sells its remaining five-year leasehold interest (the relinquished property) and enters into a five-year lease on the new space (the replacement property). The sale proceeds are used to buy down the new lease.

Although the IRS has approved some short-term leasehold interest exchanges, it has offered investors no concrete guidelines on how similar the leasehold interests must be to be considered like-kind. For instance, a 10-year leasehold interest may not be like-kind with an 18-year leasehold interest.

Leasehold Improvements

Taxpayers who want to construct replacement properties on ground owned by third parties can use improvement exchanges. A successful tax-free exchange can be completed if the leasehold improvements equal or exceed the value of the relinquished property sale at or before the 180-day acquisition period.

This technique involves the services of both a QI and an accommodation titleholder. After the relinquished property sale, the AT enters into the leasehold agreement on the taxpayer`s behalf and uses the sale proceeds to construct the improvements. Once the improvements are complete or the 180-day period has ended, the AT transfers the leasehold interest, which includes the improvements, to the taxpayer via the QI.

For example, Sheila Parks wants to sell a small $2 million retail center and enter into a 50-year ground lease that allows her to build and own leasehold improvements during the lease term. After the retail center sale, the AT enters into the leasehold agreement and uses the sale proceeds, which the QI is holding for Parks, to fund the construction. Once the improvements equal $2 million or Parks reaches the end of the 180-day period, the AT transfers the leasehold interest and improvements to Parks as her replacement property to complete the exchange.

Improvements on Taxpayer-Owned Land
Another variation of this technique is where the taxpayer builds leasehold improvements on ground it already owns or controls through a related party. A recent PLR suggests the IRS may allow such transactions if they are carefully structured. What seems to be a key factor is the existence of a 30-year or longer leasehold interest on the land. This allows for two different conveyable elements: the fee-title and the leasehold interest. By creating a separate conveyable leasehold interest, the taxpayer can increase the value of the leasehold by building improvements that can be conveyed as the final replacement property.

However, this type of exchange is extremely complicated and involves a variety of tax and legal issues. Taxpayers should consult their tax and legal professionals before attempting this type of transaction.

FF&E Exchanges
Another exchange opportunity that often is overlooked involves furniture, fixtures, and equipment, or FF&E. Many times the sale of FF&E may trigger taxable gain because the items have been depreciated. To avoid this, taxpayers can exchange old FF&E (the relinquished property) for FF&E that is purchased in the newly leased space (the replacement property).

For example, Ultra has two years left on its lease and substantial FF&E in its space. The company finds a new tenant to sublet the space and pay a reasonable amount for the FF&E. Using the sale proceeds and a QI to handle the transaction, Ultra purchases the FF&E in a new space. It also enters into a new lease, which is not part of the exchange.

While FF&E is considered personal property, not all personal property in one building may be considered like-kind to personal property in another building. A tax professional should verify that the FF&E being sold and the FF&E being acquired reasonably match. IRS regulations state that to be considered like-kind, personal property must be in same general asset class or in the same four-digit product class in the *Standard Industrial Classification Manual* .