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Combining Build-To-Suit With A Tax-Free Exchange

There is a great deal of control that can be exercised over the type of property to be received in a tax-free exchange. In one case, the taxpayer designed a brand-new building for himself to replace property to be given by him in exchange. In addition, the taxpayer provided financing for the new building's construction.

Since this was a different idea, the problem was presented to the IRS as whether the taxpayer could act as both lender and exchanging party or whether his actions amounted to a purchase of the new property (which would force him to recognize gain on the property given up).

The taxpayer owned an office building but needed additional space. An unrelated party, Mr. Smith, offered to buy the building but the taxpayer wanted a tax-free exchange to avoid the tax on the large increase in value on the property.

The taxpayer located land suitable for construction of a new building. Smith agreed to negotiate a ground lease, construct the building according to the taxpayer's requirements, and then enter into an exchange.

Smith and the landowner entered into a lease that provided as follows:

- Either Smith or an assignee of the ground lease could construct the improvements.
- The ground lessee could mortgage its leasehold interest but the landowner agreed it would not mortgage its fee interest.
- After five years, lessor and lessee each had the option to purchase or sell the land for a fixed amount specified in the lease.
- On the date of the tax-free exchange by Smith with the taxpayer, the ground lease would have a remaining term of 30 years or more (which would make the leasehold qualify for a tax-free exchange).

The taxpayer and Smith then entered into an exchange agreement under which Smith agreed to construct the new building according to plans and specifications approved by the taxpayer. The taxpayer could make changes

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to the plans before and during construction and had the right to approve costs under contracts to which Smith, the architect, the developer, or any affiliate was a party. The taxpayer could also approve the general contractor and other parties.

At the closing of the exchange, the taxpayer would convey the old building to Smith in exchange for his assignment of his ground leasehold, including the new building.

The exchange would not take place until the building was substantially completed. Its exchange value was Smith's construction costs, including fees, construction loan interest, real property taxes, and insurance. Once Smith had spent a specified amount on the project, the taxpayer would provide construction loan financing to Smith on a nonrecourse, interest bearing basis.

At or before the closing, Smith would repay to the taxpayer as much of the construction loan as was required to equalize the exchange value of the new and old buildings.

Two other relevant provisions in the exchange agreement were the following:

- ***Right to cancel.*** The taxpayer had the right, before the execution of the exchange agreement and the commencement of construction, to make environmental, zoning, and similar reviews of the land and cancel the entire arrangement if the results were unsatisfactory. In such event, the taxpayer would reimburse Smith for his expenses incurred.
- ***Leaseback.*** Immediately after the exchange, the taxpayer would lease back from Smith for 10 years (at a fair rental) the portion of the old building that contained the taxpayer's computer data center.

In its Letter Ruling, the IRS noted that courts have given taxpayers great latitude in structuring exchange transactions. For example, taxpayers may oversee improvements in land to be acquired and advance money toward the purchase of the property to be acquired in the exchange.

On the basis of the facts described in the Ruling, the IRS concluded that Smith's risks of ownership with respect to the new building were substantial enough so that a true exchange would result; put another way, Smith was not acting merely as the taxpayer's agent.

The risk of ownership included the following:

- Smith's obligations under the exchange agreement, including the construction of a building to the taxpayer's requirements.
- The taxpayer's rights as a lender with respect to the financing.
- Smith's obligation to spend a specified amount before the taxpayer would be obligated to provide financing.
- Smith's liability before the exchange for any claims made with respect to the construction or related contracts.
- Smith's obligation under the lease.

The ability of the taxpayer to exercise significant control over the design and construction of replacement property while still qualifying for a tax-free exchange broadens the attractiveness of an exchange in permitting a taxpayer to avoid recognition of the appreciation in value of the original property. ❑

Choosing The Right Investment Property

No single property can fit all of the investment goals and rules an investor has set. Even if the investor tried to build a property to specifications, he would find some things "not quite right." The investor is, therefore, wise to anticipate problems and have some basic strategies for dealing with them. Here are some suggestions to help the investor devise other approaches to meet special needs:

- **Energy saving potential is more important than style or appearance.** Given increasing shortages of natural gas and rising prices of fuel, energy saving has become paramount for successful real estate investing.
- **Location is usually more important than the buildings on the lot.** You can always make repairs and improvements to a building, but you can't do anything to change the qualities of a location.
- **An older property is preferable to a new property** if you want to be reasonably certain about income and cost potentials and are seeking the most rentable space for each investment dollar.
- **Good workmanship is preferable to good materials** if you have to make a choice. Workmanship

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can overcome the defects of poor materials, but you would pay constantly for poor workmanship. Hopefully, you can avoid this kind of choice because poor workmanship and poor materials mean extra costs and continuing problems.

- **Low down payments are preferable** because they increase the earning rates on your equity. However, be sure you have a financial reserve in case the property does not produce enough net income at times to pay for the financing.
- **Plain properties without distinctive architecture or other characteristics** are the most durable investments. Luxuries or extras may make the property look better, but they do not improve the income potential.
- **In a given market, smaller units** will usually be more saleable, easier to manage, and easier to keep rented in changing markets. Any apartment property with more than 20 units will require professional management.
- **Size of the property and units within the property** should fit the average for the market. Smaller or larger units often present problems that result in lower prices and higher costs.
- **Use experts when in doubt.** The costs of using appraisers, builders, lenders, and lawyers are considerably less than those associated with making mistakes. If your investment cannot produce enough income to let you pay for expert help, then it may be the wrong investment.
- **Convertibility**—the property should lend itself to changes as the market changes so that you can always maximize the rent potential.
- **Flexibility**—the space in the property should be easily changed to meet different user needs at minimal costs of time and money.
- **Specifying repairs to be made before buying** is a safer, less costly financial strategy. Estimate them ahead of time, thereby being able to negotiate for a lower price.
- **Financing trade-offs** –to keep loan payments low, negotiate for long-term payout bases at equivalent rates. Include in your estimates the initial costs of the loan and the repayment costs and privileges.
- **Sharing equity increase potentials with lenders** can often produce a lower rate loan on terms favorable to your investment objectives. ❏

Securing Land For Any Project

Land is always at the top of investments by real estate professionals. Before any building project can be planned, the land must be available. At all times, real estate assemblers are looking at and acquiring under-utilized sites within cities or in suburbs. Here are some ideas on how those professionals do it.

- **A thorough knowledge.** Only purchase or option property in well-known localities to reduce the risk of unexpected surprises. If the locality is not familiar, seek out local professionals for their opinions.
- **Be a follower.** Being the first to buy increases the risk of being wrong and may mean an unexpectedly long wait until values rise. It is often better to go in after values have begun to increase or after some development has started.
- **Government maps.** Local governments often have maps and plans for projected roads and highways. These can point the way to desirable acquisitions.
- **Prepare an acreage map.** The map should show the ownership of all tracts in the locality and (if known) the asking price of each. This step marks the prime difference between the professional and the non-professional land acquirer.
- **Seek out builders.** Try to find a builder willing to let you act as an intermediary in acquiring land.
- **Option or installment contract.** When acquiring property, get a firm commitment from the landowner without the buyer having to pay out cash. This can be done either with an installment contract under which the buyer can pay interest only for the period of years with a right to walk away without further penalty.

Note: An investor or investment group retained by a builder to find land is obligated to give the builder the first opportunity to buy in all cases. However, any land the builder does not want may be a good investment for the assembler since its value is likely to increase as new construction occurs. ❏

Postponement Of Federal Taxes

Internal Revenue Code Provisions

The Internal Revenue Code contains two provisions that permit the postponement of tax on the exchange of business or income real estate. Even though the term "tax-free exchange" is commonly used to describe such exchanges, tax merely is deferred on such exchanges until the chain of exchange cycle is broken by a sale.

The only exception occurs when the exchange cycle is unbroken throughout the investor's lifetime, in which case the real estate receives a stepped-up basis upon the death of the taxpayer so that no tax is ever payable on the appreciation to that date.

The two code provisions are:

1. **Section 1031**, permitting the tax-free exchange of property held for use in a trade or business or for investment.
2. **Section 1033**, permitting the owner of property that has been involuntarily converted (i.e., destroyed or condemned) to acquire other property without recognizing any gain realized as a result of the conversion.

Another Code provision, **Section 121**, as amended by the **Taxpayers Relief Act of 1997**, makes entirely tax free up to $250,000 (for an individual) and up to $500,000 (for a married couple) of realized gain on the sale of a principal residence, providing certain conditions are met. Former Section 1034, which permitted tax-free exchanges of principal residences, has been repealed.

Section 1031 is the one that takes the most professional guidance. The techniques for arranging tax-deferred real estate exchanges that meet the requirements of the participants have become quite sophisticated with increasing usage. Indeed, there are real estate professionals—real estate exchangers, like this office—who specialize in identifying properties and owners that are likely candidates for exchanges and bringing them together to make the trade.

In today's real estate world, exchanges are not limited to those arranged for two property owners. Exchanges involving three or even more participants are arranged. Actually, the more owners and properties participating in the exchange process, the easier it becomes to arrange.

Thus, every real estate investor, professional consultant, and adviser should understand the techniques for setting up tax-deferred exchanges and for analyzing the tax, financing, and economic consequences to the participants. A working knowledge of property exchange techniques requires an understanding of what constitutes a tax-deferred exchange, how it is used to advantage, and under which circumstances it should be employed.

Call us if you would like to explore the possibilities in exchanging. ❑

Your Real Estate Investment

Knowing what you can do in some investment situations can be the difference between an annual profit or loss in your currently owned commercial property or the one you intend to acquire. How you acquire it can be important.

The professional commercial real estate broker is in the position to represent a client in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. This real estate practitioner stays aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant).

In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and/or tax advisor. We always recommend consulting with these professionals during the planning and closing of major real estate transactions. All can affect taxes and estate planning.

We are the heart of your professional team, creating the real estate transactions that will be needed to expand your estate. Let's get together to evaluate your present portfolio of properties, or review your plans for future acquisition.

Starting with your present position and your goals for the future, we can set out moving directly toward achieving those goals. ❑