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## Can a 1031 Exchange Fund New Construction?

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**Question:** Is there some way of qualifying for a 1031 exchange when selling a commercial property and exchanging it into land I already own, on which I plan to develop an apartment complex?

-- Gary, Seattle

**Gary:** Yes there is a way, but the ground under this issue isn't exactly firm.

In a 1031 exchange, owners defer capital-gains taxes on the sale of their property by exchanging it for the same kind of property. In most cases, a third-party intermediary prepares the exchange agreement and handles the money. The property the seller wants to buy has to be identified within 45 calendar days of his sale and purchased within 180 days.

There has long been uncertainty about how the Internal Revenue Service views 1031 transactions in which investors seek to use the proceeds from a property sale to construct a new property on vacant land owned or leased by an affiliate of the investor.

Regarding a transaction involving vacant land, tax advisers and investors have been concerned about perceptions of self-dealing when such land was leased or owned by an affiliate of the exchanger. They also wondered if new construction on an empty parcel could be considered replacement property.

But two IRS rulings -- one released in 2003 and the other in late 2002 -- say these kinds of transactions can qualify as 1031 exchanges.

The rulings essentially approve the construction, through a so-called exchange accommodation titleholder, of a new building on land already leased to an affiliate of the exchanging taxpayer as valid replacement property for a 1031 exchange, says Robert D. Schachat, director of the real-estate group in the national tax department of Ernst & Young LLP in Washington, D.C.

The exchange accommodation titleholder is the legal entity that holds the title to the property while the exchange is being conducted. For all of this to be legit, the landowner, whether an affiliate or third party, must sign a lease of 30 years or more with the exchange accommodation titleholder that will construct the building on the land. When the building is complete, or near complete, the investor can sell the old property and use the proceeds to buy the new property and the lease interest from the titleholder.

What you seek to do would be permitted if the land were already owned by an affiliate. However, if the land is already owned by the taxpayer (you), the issue becomes much more difficult. In 1967, the IRS issued a ruling that states that a new building constructed on land already owned by the exchanging taxpayer cannot qualify as replacement property under the like-kind requirement of section 1031.

Mr. Schachat says some tax advisers believe that there is a significant likelihood that the IRS position in the 1967 ruling is incorrect. If so, a new building constructed on land already owned by the exchanging taxpayer could qualify as replacement property in a 1031 exchange.

A safer approach, Mr. Schachat suggests, might be to accept the IRS position but to try to avoid the restriction by transferring the undeveloped land to an affiliate well in advance of the exchange. "We understand that the IRS is considering this specific issue and may publish additional guidance in the next few months," he says.

*-- Mr. Smith is a staff reporter for The Wall Street Journal. His "Building Value Q & A" column appears each month exclusively on RealEstateJournal. [Click here](#) to e-mail him a question about investing in real estate.*