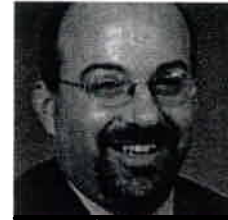


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INSIDER: New Law Adds Complexity to Tax-Motivated Real Estate Transactions Involving Property Leased to Tax-Exempt Lessees

By John Balboni and
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When it's time to sell, many real estate owners face the prospect of paying tax on capital gains generated by appreciation in their property's value. Frequently, these owners seek to defer paying these taxes by entering into Section 1031 like-kind exchanges. As a matter of public policy, these tax-deferral benefits encourage owners to reinvest their sale proceeds in like-kind assets. However, Section 470 of the tax code—enacted as part of the Jobs Creation Act of 2004—dramatically impacts the availability of these tax-deferral benefits under certain circumstances. Real estate owners, sponsors, promoters and practitioners must be aware of the Section 470's possible impact on transactions structured to reap the tax-deferral benefits available under Section 1031.

First, a little background. Section 470 was designed to limit deductions allocable to property used by government or other tax-exempt entities. Through this provision, Congress specifically looked to attack "sale-in, lease-out" (SILO) transactions designed to shift certain tax benefits from nontaxable persons (such as governments) to taxable parties that could use such tax benefits. SILO transactions typically involved the sale of real estate owned by a tax-exempt entity to a taxable party followed immediately by a leaseback of such real estate to the tax-exempt entity. However, as discussed below, Section 470 also limits such property's use as like-kind property for purposes of Section 1031.

Real Estate Transactions, Tax Deferral and the "470" Problem

Many real estate transactions are designed to permit investors to obtain tax-deferral benefits under Section 1031. For individuals with large gains looking to make sole-ownership investments, real estate advisory firms will often engineer solutions, such as net-lease and other credit-tenant transactions that allow tax-deferred investment. For investors with gains looking to invest smaller amounts of capital and/or get the advantage of broader diversification, tenant-in-common structures have emerged—and are now one of the hottest products in the real estate industry. Section 470 provides that property leased in whole or in part to a government or other tax-exempt entity may not qualify as either exchanged or replacement property in a 1031 transaction. Therefore, this new provision could eliminate an entire category of properties from inclusion as part of tax-deferred real estate solutions. As discussed below, Section 470 need not be fatal to 1031 transactions. However, if a property involves a government or tax-exempt lessee, analysis of the property, the property's lease(s) and the overall deal economics is required.

Tax-Exempt Use Property: The Critical Question

A threshold question governing whether Section 470 applies to a property is whether or not such property is "tax-exempt use property." If the property isn't—i.e., the answer is "no" to all of the questions below—then Section 470 does not apply and such provision will not limit the property's suitability for a 1031 transaction.

A property is generally considered "tax-exempt use property" if the answer is "yes" to one or more of the following questions:

- Was the property financed in whole or in part by an obligation bearing tax-exempt interest, and did the government or other tax-exempt entity participate in the financing?
- Does the government or other tax-exempt lessee have an option to purchase the property at a fixed or determinable purchase price?
- Is the lease term for a period greater than 20 years?
- Was the property acquired from a government or other tax-exempt entity in a sale-leaseback transaction?

Owning "tax-exempt use property" forces further analysis and does not negate, by itself, the tax benefits of a like-kind exchange. In order for such property to be treated as replacement or exchanged property in a 1031 transaction, Section 470 mandates that:



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- Only an allowable amount of funds (as specified in Section 470) may be set aside for purposes of satisfying any lessee options or other lessee lease obligations;
- The lessor has—and maintains—a substantial capital investment in the property;
- The lessee bears no more than a minimal risk of loss; and
- For most property, any purchase option must have a purchase price equal to fair market value determined at the time that such option is exercised.

Whether a lease meets the requirements of Section 470 is measured at the time the lease begins and not at the time the property that is the subject of the lease is sold as exchanged or acquired as replacement property. The majority of these issues can be resolved by reference to a property's lease(s). However, other documentation and deal structure elements must be carefully vetted to ensure that other factors do not violate these new requirements.

Section 470 is yet another potential pitfall when structuring real estate transactions seeking 1031 exchange treatment. To the extent that real estate owners, sponsors and their advisors encounter property leased in whole or in part to a tax-exempt entity, including governments, they must investigate the property, the property's lease(s) and the overall economics of a transaction. Only when such investigation is complete can it be determined if such property can be part of a 1031 transaction. As always, parties should seek competent tax advice to assist in this analysis.

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