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## Valuable Information for Real Estate Professionals and their Clients

# LEASEHOLD INTERESTS

### ARE LEASEHOLDS CONSIDERED TO BE "LIKE-KIND"?

Typically 1031 transactions involve the exchange of real estate held for investment or business purposes. Fee-title investment real estate is the most common type of property exchanged, but other ownership interests may be utilized as well.

Leasehold interests may be either relinquished property or replacement property in an exchange. A lease with a remaining term of 30 years or more is considered to be "like-kind" to a fee interest in real estate. If the lease has optional renewal periods, these periods can be included in determining whether the leasehold interest has 30 years or more to run. In one case, a lease with an initial term of 5 years and ten optional renewal periods of 5 years each was held to be "like-kind" property since the taxpayer had the right to use the property for up to 55 years. [R & J Furniture Co. v. Comm., 20 T.C. 857 (1953)]

### ADDITIONAL REQUIREMENTS

In meeting the leasehold interest term requirement, the option to extend the leasehold interest must be the tenant's and not the landlord's. In Technical Advice Memorandum 200346007, the Service ruled that a 26-year lessee's leasehold interest acquired by the taxpayer in a sale-leaseback was not like-kind to a fee interest, even though the lessor had a renewal option for an additional 14 years and could therefore force the taxpayer to extend the lease beyond 30 years. The Service ruled that the right to extend the leasehold did not belong to the taxpayer as lessee.

### EXAMPLE OF A LEASEHOLD INTEREST EXCHANGE:

Bob Jones wants to use a 1031 exchange to sell a \$500,000 parcel of bare land and purchase an existing lease on a fishing lodge and 600 acres of recreational land for \$600,000. The 15-year lease has two 10-year extensions. Pursuant to the lease, the lessee retains the option to exercise the extensions. Therefore the leasehold interest length is 35 years. This transaction would be in compliance with IRS guidelines.

### ADDITIONAL CONSIDERATIONS

- ▶ A "carve out" of a leasehold interest does not qualify for 1031 exchange treatment. For example, a fee owner of real property cannot exchange a "carve out" 30-year leasehold interest in their real property for a fee interest in a replacement property.
- ▶ A taxpayer who wants to construct leasehold improvements on ground owned by third parties can implement improvement exchanges. In order to defer all capital gains taxes, the leasehold improvements, along with the value allocated to the lease, should equal or exceed the value of the relinquished property before the conclusion of the 180-day acquisition period.

This structure involves the use of an Exchange Accommodation Titleholder (EAT), as well as a Qualified Intermediary. The EAT enters into the leasehold agreement on the taxpayer's behalf. Please consult with a Qualified Intermediary for further details on improvement exchanges.