Can You Build on Property You Already Own?
The Leasehold Improvement 1031 Exchange Strategy

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Real estate investors frequently find themselves holding valuable investment property, often vacant unimproved land, with no options left to build it out, at least, not without triggering a taxable event. What happens when the best "replacement property" option for your 1031 exchange is building on the real property that you already own or control, generally through a *related party or entity*?

Conventional wisdom says you can't exchange into real estate that you already own. But for investors who understand the technical architecture of a leasehold improvement 1031 exchange, there is a path forward, provided it is built on a foundation of careful planning, qualified legal and tax guidance, and a clear-eyed understanding of the risks involved.

This article examines how leasehold improvement 1031 exchanges, sometimes referred to as an advanced improvement 1031 exchange, build-to-suit exchange or construction exchange, can be structured to allow investors to make capital improvements on property they already own or control, and why this strategy, while increasingly validated by IRS guidance, remains one of the most structurally challenging and complicated transactions in the tax-deferred exchange universe.

The Core Problem: You Can't Exchange with Yourself

Section 1031 of the Internal Revenue Code requires a genuine exchange of like-kind property. By definition, a tax-deferred exchange requires a reciprocal transfer between two parties. When an investor already owns both the relinquished property and the land they want to build capital improvements on, no such reciprocal transfer exists on its face. The IRS has been exceptionally clear on this point. Revenue Procedure 2004-51 states plainly: "An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of Code Sec. 1031."

This is not a technicality to be waived away. It reflects decades of case law, including Bloomington Coca-Cola Bottling Co. v. Commissioner and DeCleene v. Commissioner, in which courts disallowed like kind exchanges where the accommodating party never genuinely acquired the benefits and burdens of ownership of the replacement property. In DeCleene, the Tax Court was particularly pointed in its reasoning: because no qualified intermediary or accommodation structure was used, and because the "buyer" never bore any real economic risk, the transaction was recast as a taxable sale rather than a tax-deferred exchange.

The lesson for investors is clear: form matters, but only when the form reflects economic substance. A transaction that is structured to look like an exchange while functioning as a disguised improvement project on the taxpayer's own land will not survive an audit.

How the Structure Actually Works

So how can an investor legitimately use net proceeds from the sale of their relinquished property to construct capital improvements on real estate they already control? The answer lies in creating a brand-new interest in real property that did not previously exist and that the investor does not currently own.

The mechanics generally proceed as follows:

1. The relinquished property is sold through a qualified intermediary, such as Exeter 1031 Exchange Services, LLC (Exeter1031™), which holds the net exchange proceeds in a separate, segregated, dual-signature, restricted qualified trust account. Exeter Trust Company (ExeterTrust™), which is licensed, regulated and audited by the Wyoming Division of Banking, serves as trustee for the qualified trust account.

2. An exchange accommodation titleholder (EAT), such as Exeter Asset Services Corporation, forms a single-member limited liability company (SMLLC), a disregarded entity for federal tax purposes, to serve as lessee under a long-term lease.

3. The SMLLC enters into a long-term ground lease, typically 30 years or more (commonly structured at 32 years to provide a buffer above the minimum), on the real estate the investor already owns. This lease creates a new leasehold interest in real property that did not exist before the transaction began.

4. The SMLLC either borrows funds from the investor or borrows funds through a construction lender arranged by the investor, or in some cases uses exchange funds to construct capital improvements on the leased property, acting in its own name and for its own account throughout the construction period.

5. Within 180 calendar days, the completed leasehold interest consisting of the ground lease plus the capital improvements built upon the property, is transferred to the investor as their replacement property, thereby completing the 1031 exchange.

The resulting replacement property is not the land itself, which the investor already owned or controlled, but rather the newly created leasehold interest and the capital improvements built on the property. This distinction is the entire basis on which the strategy can qualify under Section 1031.

The Regulatory and Case Law Foundation

This structure did not emerge from aggressive tax planning in a vacuum. It is grounded in Revenue Procedure 2000-37, which established the safe harbor for parking arrangements using a qualified exchange accommodation arrangement (QEAA), and in a trio of Private Letter Rulings (PLRs) that have examined similar fact patterns:

- PLR 2002-51008 (December 20, 2002)
- PLR 2003-29021 (July 18, 2003)
- PLR 2014-08019 (February 21, 2014)

The Treasury Department approved a structure in these Private Letter Rulings in which an exchange accommodation titleholder or “EAT” acquired a leasehold interest, then constructed capital improvements, and subsequently transferred the completed leasehold interest and capital improvements to the taxpayer as their replacement property within the 180 calendar day exchange safe harbor window. Tax commentators have noted that the 2014 ruling was particularly significant, arriving a full decade after the IRS announced in Revenue Procedure 2004-51 that it was "continuing to study" these parking transactions, a statement that had a chilling effect on the industry for years. Its issuance signaled that properly structured leasehold improvement exchanges could proceed with greater confidence.

It is critical to understand, however, what these rulings do and do not establish. In each case cited above, the property they made capital improvements to was already owned or controlled by a *related party* to the taxpayer but not the actual taxpayer directly. This "advanced" improvement 1031 exchange, generally referred to as a leasehold improvement 1031 exchange, in which the taxpayer already owns or controls the underlying land they wish to build on through a related party, extends this logic a step further and carries elevated risk as a result.

Why This Strategy Demands Extraordinary Caution

Private Letter Rulings Can Not Be Cited as Precedent

This point cannot be overstated. Under Section 6110(j)(3) of the Internal Revenue Code, a Private Letter Ruling may be relied upon only by the taxpayer who requested it. No other investor can cite these rulings as binding authority in an audit. While the existence of three favorable PLRs addressing this structure is a meaningful indicator of the IRS's general disposition, it is not a guarantee. The IRS retains the authority to disallow a leasehold improvement 1031 exchange even when it closely tracks the structure of an approved PLR.

Deviation From the Rulings Increases Risk

Every one of the three governing PLRs involved a factual pattern in which the relinquished property and the replacement property were held by different, though related, taxpayers. When the same taxpayer owns both the relinquished property and the land to be improved, the transaction deviates from the precise fact pattern the IRS has approved. This deviation is significant. Investors who wish to mitigate this risk by transferring the underlying land to a related party before initiating the exchange must also observe the 180 calendar day look-back rule imposed by Revenue Procedure 2004-51, which excludes from the safe harbor any replacement property owned by the taxpayer within the 180 calendar days preceding the EAT's acquisition of an interest in that property. A last-minute ownership transfer, undertaken without sufficient time to "season" the new ownership, substantially increases the risk that the IRS will recharacterize the entire arrangement as a step transaction and disallow the like-kind exchange.

The Agency Doctrine Looms Over Every Build-to-Suit Exchange

Because a leasehold improvement 1031 exchange necessarily involves significant taxpayer participation in directing construction, there is heightened exposure to the argument that the exchange accommodation titleholder is merely acting as the taxpayer's agent rather than as a genuine, independent third party bearing the benefits and burdens of ownership. Courts applying the six-factor agency test from National Carbide Corp. v. Commissioner, as reaffirmed by the Supreme Court in Commissioner v. Bollinger, examine whether the accommodating entity operates in its own name, binds the principal by its actions, and genuinely bears economic risk. A structure that fails this analysis risks recharacterization as a taxable sale followed by the purchase of construction services and not a like-kind exchange.

The 180-Day Window Is Unforgiving

Regardless of how the transaction is structured, the exchange accommodation titleholder's holding period is capped at 180 calendar days to stay within the safe harbor guidelines. If construction is not complete by that date, only the value of the capital improvements actually completed will qualify as replacement property. Any exchange funds used for construction occurring after the property transfers to the taxpayer become taxable. For large-scale development projects, this timing constraint alone can materially limit the tax deferral available through this strategy.

These Are Materially More Expensive Transactions

Unlike a standard forward 1031 exchange, which typically carries a set-up fee in the range of $1,100 to $1,800, leasehold improvement 1031 exchanges and other advanced parking arrangements generally carry fees in the range of $7,500 to $15,000 or more. This reflects the substantially higher complexity, documentation burden, and risk profile inherent in administering these transactions. Investors should factor these costs into their overall analysis of whether the strategy delivers sufficient tax deferral benefit relative to its administrative expense.

The Qualified Intermediary Industry Lacks Regulatory Oversight

Perhaps the most overlooked risk in any like-kind exchange structure is the risk of using an unregulated qualified intermediary and exchange accommodation titleholder. The 1031 exchange qualified intermediary industry has no licensing body and no regulatory authority providing independent oversight. Most qualified intermediaries operate without any form of government licensing, regulatory audit, or minimum insurance or equity capital reserve requirements. This is a critical distinction for investors to understand, given the significant sums of exchange proceeds that pass through a qualified intermediary's control during a leasehold improvement 1031 exchange, often for extended periods while construction is underway.

Before engaging any qualified intermediary for any tax-deferred exchange transaction, investors should ask the QI directly:

- Are you licensed by any government or regulatory agency, and if so, which one?
- Are you subject to direct regulatory or government audit?
- Do you carry fidelity bond, errors and omissions, financial institution blanket bond, and cyber/wire transfer fraud insurance coverage?
- Are exchange funds held in separate, segregated, dual-signature, restricted qualified trust accounts or qualified escrow accounts?

Exeter 1031 Exchange Services, LLC (Exeter1031™) deposits, holds, and safeguards client exchange funds in separate, segregated, dual-signature, restricted qualified trust accounts with Exeter Trust Company (ExeterTrust™), which is licensed, regulated, and audited by the Wyoming Division of Banking. This makes Exeter one of the few qualified intermediaries with any form of regulatory oversight. In a leasehold improvement 1031 exchange, where funds may be disbursed incrementally to pay contractors over the course of construction, this level of institutional safeguard and protection is not a convenience. It is a necessity.

Why Expert Guidance Is Non-Negotiable

A leasehold improvement 1031 exchange sits at the intersection of real estate law, tax law, corporate entity structuring, and construction administration. The structural decisions made at the outset, such as how the SMLLC is formed, how the ground lease is drafted, how construction disbursements are documented, how the relationship between the taxpayer and the EAT is papered, will determine whether the transaction will withstand IRS scrutiny years later.

Investors considering this strategy should insist on advisors who can speak fluently to:

- The precise requirements of Revenue Procedure 2000-37 and its modification under Revenue Procedure 2004-51
- The specific fact patterns and limitations of the Private Letter Rulings
- The agency doctrine factors established in National Carbide and Bollinger
- The structural distinctions between standard build-to-suit exchanges and advanced build-to-suit exchanges where the taxpayer already owns or controls the underlying land through a related party

A qualified intermediary with deep, demonstrated experience in advanced exchange structures functions as far more than a transaction processor. The role demands active collaboration with the investor's legal, tax, and financial advisors throughout the planning and execution of the exchange.

A Strategy with Real Potential and Real Risk

Leasehold improvement 1031 exchanges offer investors a legitimate, IRS-recognized path to defer capital gains, depreciation recapture, and applicable state taxes while unlocking the development potential of property they already hold or control through a related party or entity. The strategy's foundation in Revenue Procedure 2000-37 and three supportive Private Letter Rulings reflects meaningful validation. But this is not a strategy for investors seeking a simple, low-friction transaction. It is a sophisticated structure that demands precision, significant fees, extended professional coordination, and an honest accounting of the risks involved, including the ever-present possibility that the IRS could still disallow the structure upon audit.

Next Steps

Before proceeding with a leasehold improvement 1031 exchange of any kind, and particularly before attempting to build on property you already own, investors must consult with their own legal, tax, and financial advisors to review the applicable Private Letter Rulings and determine how best to structure the transaction for their specific circumstances. The Private Letter Rulings discussed in this article are not a template to be copied; they are a framework to be studied, adapted, and implemented with the guidance of professionals who understand both the opportunity and the exposure involved.

Exeter 1031 Exchange Services, LLC, together with Exeter Asset Services Corporation serving as exchange accommodation titleholder, has extensive experience structuring advanced exchange transactions with clients' advisors, including leasehold improvement 1031 exchanges. For investors evaluating whether this strategy is appropriate for their circumstances, our 1031 specialists are available to work alongside your legal, tax, and financial advisors to review the governing Private Letter Rulings and determine the most sound approach for your transaction.

Frequently Asked Questions

Q: Can a taxpayer really use a 1031 Exchange to make capital improvements on land they already own?

Yes, but only through a carefully structured arrangement that creates a new leasehold interest in the property rather than exchanging into land the taxpayer already owns through a related party. In this structure, Exeter Asset Services Corporation, acting as exchange accommodation titleholder, forms a single-member LLC that enters into a long-term ground lease on the taxpayer's existing land held by or through a related party. The completed leasehold interest consisting of the ground lease plus the capital improvements is then transferred to the taxpayer as the replacement property. While three IRS Private Letter Rulings (PLR 2002-51008, PLR 2003-29021, and PLR 2014-08019) have approved similar structures, these rulings can only be relied upon by the taxpayers who requested them and cannot be cited as precedent by others. The risk profile of this strategy is materially elevated when the taxpayer already owns the underlying land in the exact same name (same taxpayer), rather than through a related party, which deviates from the precise fact patterns addressed in those rulings. Investors must have their legal, tax, and financial advisors conduct a thorough review of the applicable Private Letter Rulings and determine the appropriate structure before proceeding.

Q: Since the IRS issued favorable Private Letter Rulings on this structure, can an investor rely on those rulings to proceed with confidence?

No. Private Letter Rulings can only be relied upon by the specific taxpayer who requested it. No other investor can cite PLR 2002-51008, PLR 2003-29021, or PLR 2014-08019 as controlling authority in an IRS audit or court proceeding. While the existence of three favorable rulings signals a degree of IRS acceptance for properly structured leasehold improvement 1031 exchanges, that acceptance is conditional, and does not extend to transactions that deviate from the precise fact patterns those rulings addressed. Critically, each of the three rulings involved replacement property land held by a related party to the taxpayer, not the taxpayer directly. When the taxpayer already owns the underlying land outright (same taxpayer), the transaction departs from those approved fact patterns in a material way, meaningfully increasing the risk that the IRS would likely disallow the exchange upon audit. Before proceeding with any leasehold improvement 1031 exchange, and particularly one involving land the taxpayer already owns, investors should engage qualified legal, tax, and financial advisors to conduct an independent review of the applicable Private Letter Rulings and assess whether the proposed structure can be documented and executed in a manner sufficient to withstand IRS scrutiny.

Q: What role does the long-term ground lease play in making this structure work, and what happens if the lease terms are challenged?

The long-term ground lease is the structural cornerstone of a leasehold improvement 1031 exchange. It is what creates the new leasehold interest that serves as replacement property. Without a genuine, long-term ground lease between the exchange accommodation titleholder's SMLLC and the related party of the taxpayer-landowner, there is no new property interest to 1031 exchange into, and the entire transaction collapses. The IRS and courts scrutinize whether the lease reflects arm's-length terms, whether the EAT bears genuine economic risk as lessee,

and whether the lease term meets the statutory minimum—typically 30 years or more when renewal options are included, commonly structured at 32 years to provide an adequate buffer. A lease that is too short, too favorable to the taxpayer, or structured in a way that suggests the EAT has no independent economic stake in the arrangement may be treated as a sham or step transaction, causing the IRS to recharacterize the transaction as a taxable sale. Additionally, if the ground lease is challenged and set aside on legal grounds, for example, due to a defect in construction of the lease, execution or a conflict with an existing mortgage or title encumbrance on the land, the replacement property effectively ceases to exist, leaving the investor without a qualifying exchange and fully exposed to the capital gain taxes the transaction was designed to defer. Investors and their legal, tax, and financial advisors should conduct careful title review, ensure the ground lease is properly drafted, documented and recorded, and confirm that no existing liens or encumbrances on the land would interfere with the EAT's ability to hold a valid leasehold interest throughout the 180-day exchange period.

Q: What happens if construction is not completed within the 180-day exchange period?

Only the value of capital improvements actually completed and transferred to the taxpayer within the 180-calendar day window will qualify as like-kind replacement property. Any construction costs incurred after that deadline, or any exchange funds disbursed for work not yet completed at the time of transfer, will not qualify for tax deferral and may be treated as taxable boot. This timing constraint is particularly unforgiving for large-scale development projects, where construction delays caused by weather, permitting, contractor performance, or supply chain disruptions can easily push completion past the deadline. Investors considering this strategy should conduct thorough due diligence on construction timelines before initiating the exchange, obtain realistic completion estimates from qualified contractors or builders, and build in meaningful schedule contingency. Investors and their legal, tax, and financial advisors should carefully evaluate whether the scope of intended improvements is realistically achievable within the statutory timeframe before committing to this structure.

Q: How should an investor evaluate and select a Qualified Intermediary for a Leasehold Improvement 1031 Exchange, and what role does Exeter play in this structure?

Selecting the right qualified intermediary is among the most consequential decisions an investor will make in any 1031 exchange, and the stakes are significantly higher in an advanced leasehold improvement 1031 exchange, where exchange funds may be held and disbursed incrementally over the full 180-day construction period. The qualified intermediary industry has no dedicated licensing body or regulatory authority providing independent oversight. Most qualified intermediaries operate without any form of government licensing, regulatory examination, or minimum insurance or equity capital reserve requirements. This creates real risk that investors must assess carefully before proceeding. Investors should ask any prospective qualified intermediary whether it is licensed and regulated by a government or regulatory agency, whether it is subject to independent audit, whether it carries fidelity bond, errors and omissions, financial institution blanket bond, and cyber and wire transfer fraud insurance, and whether exchange funds are held in separate, segregated, dual-signature, restricted qualified trust accounts rather than commingled in a corporate account. Exeter 1031 Exchange Services, LLC (Exeter1031™) deposits, holds, and safeguards client exchange funds in separate, segregated, dual-signature, restricted qualified trust accounts with Exeter Trust Company (ExeterTrust™). ExeterTrust™ is licensed, regulated, and audited by the Wyoming Division of Banking, making Exeter1031™ one of the few qualified intermediaries in the country with any form of independent regulatory oversight. In this structure, Exeter Asset Services Corporation serves as the exchange accommodation titleholder, forming the SMLLC that enters into the long-term ground lease and directs construction on the taxpayer's land, while Exeter 1031 Exchange Services, LLC serves as the qualified intermediary, holding and disbursing exchange proceeds throughout the process. Investors and their legal, tax, and financial advisors should carefully evaluate the qualifications, regulatory standing, insurance coverage, and internal controls of any qualified intermediary before entrusting it with this level of structural responsibility.

Q: What documentation should be in place before and during an Advanced Leasehold Improvement 1031 Exchange?

Documentation is not a formality in this structure. It is the foundation upon which the entire transaction's tax treatment rests. If the IRS audits the exchange, the documentation record will be the primary evidence of whether the EAT genuinely acquired and held a leasehold interest as an independent party, whether construction was completed within the 180-day period, and whether the transfer of the completed leasehold interest to the

taxpayer constituted a qualifying like-kind exchange. At a minimum, the transaction record should include a fully executed qualified exchange accommodation agreement between the taxpayer and Exeter Asset Services Corporation, acting as EAT; the SMLLC formation documents, including operating agreement and state filing confirmation; a properly drafted and recorded long-term ground lease between the SMLLC and the related party for the taxpayer-landowner, reflecting arm's-length terms and a lease period of 30 years or more; a construction management or contractor agreement entered into by the SMLLC in its own name; detailed construction; and the exchange agreement and assignment documents reflecting the formal transfer of the completed leasehold interest to the taxpayer as replacement property within the 180-day window. Investors should work closely with their legal, tax, and financial advisors—as well as with Exeter's advisory team—to ensure that all required documents are prepared, executed, and maintained in a manner consistent with the governing Private Letter Rulings and applicable Treasury Regulations.

Q: What are the federal income tax consequences if the IRS disallows the exchange upon audit?

The consequences of a failed advanced leasehold improvement 1031 exchange can be severe. If the IRS successfully recharacterizes the transaction as a taxable sale, the investor will owe federal capital gains tax, potentially at the top long-term gain rate of 20%, on the full amount of gain realized on the sale of the relinquished property, plus depreciation recapture, plus the 3.8% Net Investment Income Tax if the investor's modified adjusted gross income exceeds applicable thresholds. Depending on the state in which the relinquished property was located and the state of the investor's residence, additional state income taxes may also apply. In many cases, the combined federal and state tax burden on a disallowed exchange can easily exceed 35% of the gain realized. Penalties for underpayment of tax may also apply. Interest on the underpaid tax accrues from the original due date of the return. These potential consequences underscore why the investment in competent legal, tax, and financial counsel before initiating the transaction is not optional, it is the most cost-effective risk management available to investors pursuing this strategy.

Q: Can this structure be used to fund any capital improvements, or are there restrictions on what qualifies?

The improvements funded through a leasehold improvement 1031 exchange must constitute capital improvements to real property, not personal property and not repair and maintenance expenditures. Qualifying expenditures generally include construction of new structures, additions to existing structures, site improvements such as grading and paving, and infrastructure costs that are capitalized under applicable tax accounting rules. Non-qualifying expenditures, such as routine repairs, operating costs, management fees, or purchases of personal property that are not permanently affixed to the real property, will not count as replacement property value and may be treated as taxable boot if included in the disbursement of exchange proceeds. Additionally, improvements must be made to the leasehold interest held by the EAT's SMLLC, not to the underlying land itself, since the land remains the property of the taxpayer throughout the transaction. Investors and their legal, tax, and financial advisors should work with qualified accountants and construction professionals to ensure that a clear line is drawn between capital improvements that will qualify as replacement property and expenditures that will not, and that the exchange fund disbursement records accurately reflect that distinction.

Q: Is there any risk that the SMLLC formed by the Exchange Accommodation Titleholder could be treated as a disregarded entity in a way that undermines the exchange?

This is a nuanced but important structural question. The SMLLC formed by Exeter Asset Services Corporation is intentionally structured as a disregarded entity for federal income tax purposes, meaning that, for tax accounting purposes, the EAT and the SMLLC are treated as the same taxpayer. This treatment is essential to the structure because it allows the EAT, rather than the taxpayer, to be treated as the owner of the leasehold interest for tax purposes of the exchange. However, this same treatment creates a potential tension, if the SMLLC is disregarded for tax purposes, one could argue that the EAT, and therefore the taxpayer through the EAT's role, is effectively contracting with itself when the SMLLC enters into the ground lease with the related party to the taxpayer-landowner. The governing Private Letter Rulings addressed and approved this structure by treating the EAT as the relevant party for purposes of the exchange, notwithstanding the SMLLC's disregarded status. However, because those rulings are not binding precedent, the IRS could take a different position in a subsequent audit. Investors and their legal, tax, and financial advisors should carefully analyze how the disregarded entity treatment of the SMLLC

interacts with the exchange structure and document the transaction in a manner that clearly supports the EAT's status as the genuine holder of the leasehold interest throughout the 180-day period.

Q: What should an investor do if they are considering this strategy but are uncertain whether their specific situation qualifies?

The first and most important step is to engage qualified legal, tax, and financial advisors who have specific experience with sophisticated 1031 exchange structures, not general real estate attorneys or tax preparers who may be unfamiliar with the technical requirements of Revenue Procedure 2000-37, Revenue Procedure 2004-51, and the governing Private Letter Rulings. Once a professional advisory team is in place, investors should request a detailed structural analysis of their specific facts and circumstances, including the nature and value of the relinquished property, the ownership structure of the land to be improved, the scope and timeline of the intended construction, and the availability of a qualified exchange accommodation titleholder and qualified intermediary with demonstrated experience in this structure. Exeter 1031 Exchange Services, LLC and Exeter Asset Services Corporation are available to work alongside your legal, tax, and financial advisors to evaluate the feasibility of this structure for your specific transaction, review the applicable Private Letter Rulings in the context of your facts, and provide guidance on how to document and administer the exchange in a manner designed to withstand IRS scrutiny. Given the complexity of this strategy and the magnitude of the tax consequences at stake, investors should allow sufficient lead time before the anticipated sale of the relinquished property to conduct thorough planning, engage all necessary advisors, and put the required structural documents in place before the exchange clock begins to run.