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Illustration by Dennis Wunsch



Making an Eco-Conscious

EXCHANGE



Like-kind 1031 exchanges have green applications, among others, for some borrowers

For decades, sophisticated property-investors have used U.S. Internal Revenue Code Section No. 1031 tax-deferred exchanges for real estate or personal property as an efficient tax-mitigation strategy. These exchanges have numerous benefits and potential applications to investment strategies, too.

As commercial property-owners continue to become more environmentally conscious, using a 1031 exchange when selling a property and purchasing another, “like-kind” property can help them accomplish their green objectives. Commercial mortgage brokers who understand basic 1031 principles, as well as how these strategies work and their potential effects, can best help their clients attain their goals.

Here's how. >>



Making an Eco-Conscious Exchange

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There are various 1031-exchange methods for property-owners. The most-common is a forward exchange. In it, a property-owner sells a relinquished property and acquires a replacement property within the necessary time frame. Other exchange structures include reverse, construction or build-to-suit, leasehold, and multi-asset exchanges.

In a successful forward exchange, an unrelated third party known as a qualified intermediary receives client exchange funds — aka, cash boot — when clients sell the relinquished property. The intermediary provides those same funds at the closing for the replacement property.

Upon acquisition of the replacement property, any debt of which the property-owner was relieved in the relinquished-property sale — aka, mortgage boot — also must be replaced. The property-owner must identify the replacement property within 45 calendar

days of the closing of the relinquished-property sale and must acquire it — or one of them, if multiple — within 180 calendar days from the start of the transaction. To defer all capital-gains taxes on the transaction, the property-owner must purchase one or more replacement properties that equal or exceed the relinquished property’s value.

Property-investors can realize many benefits from using a 1031-exchange strategy. These include the following:

- **Immediate — and potentially indefinite — tax deferral:** When selling an investment or business-related property, property-owners may defer the capital-gains tax as long as they acquire a like-kind replacement property. The deferred tax is not due until they decide to sell property without performing an exchange. Tax may be deferred indefinitely when an exchange strategy is coupled with proper estate-planning strategies.
- **Improvement of investment returns:** Investors may wish to sell an underperforming asset and acquire an asset with a more attractive cash flow, better appreciation potential or less risk. Additionally, a property-owner may wish to trade a nonincome-producing asset, such as raw land, for one that produces positive cash flow, such as a retail shopping center.
- **Consolidation or diversification of real estate holdings:** Property-investors may accumulate multiple properties and eventually decide to consolidate these holdings into a few larger assets. Conversely, they may own only one substantial property and want to diversify their holdings.
- **Wealth-building potential:** The greatest potential benefit that comes from using a 1031 exchange is the property-owner’s ability to preserve equity in the



Illustration: Dennis Wunsch

relinquished property. The compounding effect of earning a continual return on all of the equity, instead of a portion of it, via the deferral of taxes due at the time of disposition can create a greater overall yield for the investor.

Green exchange strategies

In the past few years, many individuals and corporations have implemented efforts to

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become more eco-conscious. At the corporate level, many companies are adopting green and carbon-neutral practices. This may include owning or leasing office space certified by the U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) program or retrofitted with energy-efficient fixtures or alternative-energy capabilities.

As part of this movement, business-owners may wish to consider exchange strategies that can help them improve efficiencies and financial returns while also achieving eco-friendly goals.

At the most basic level, they may implement a 1031-exchange strategy whereby they sell their current assets and replace them with more environmentally friendly assets. Examples include:

- **Selling an older, less-energy-efficient building** and purchasing a newly constructed and energy-efficient or LEED-certified building;
- **Selling income-producing assets** and purchasing raw land for carbon-offset purposes; and
- **Purchasing raw land as replacement property** and ultimately donating this property to a land trust as part of the taxpayer's conservation and philanthropic efforts.

At the personal-property level, business-owners may exchange less-energy-efficient fixtures or equipment for newer, eco-friendly assets. Companies may sell their entire fleet of vehicles and exchange into hybrid vehicles or vehicles that use alternative clean-tech fuels, for example. Or they may sell older, less-efficient industrial equipment and replace it with more-energy-efficient models.

Building green

Apart from using a forward 1031 exchange to accomplish green objectives, property-owners also may do so via construction or build-to-suit exchanges.

In a construction-exchange transaction, owners may acquire land and construct improvements or purchase a building and perform renovations. In these transactions, property-owners can ensure that construction improvements or renovations follow LEED-certification or energy-efficient

recommendations. These can include every aspect of construction, from implementing water-efficient landscaping design, known as xeriscaping, to incorporating alternative energy sources, such as wind or solar, to construction that incorporates more-energy-efficient windows and light fixtures.

To complete a construction exchange, property-owners and their brokers must understand the three distinct transaction steps:

- 1. First, a third party purchases the relinquished property.** Any mortgage liabilities are paid, and the intermediary holds the remaining cash boot on the taxpayer's behalf. This cash is used for purchasing the replacement property, improving it or both.
- 2. Next, the to-be-improved property is parked.** The taxpayer may not take title to the replacement property while the improvements are under way. Rather, the qualified intermediary establishes a wholly separate holding company — called an accommodation titleholder — and holds the replacement property in this new entity during the improvement part of exchange.

The accommodation titleholder typically is a newly formed, single-member entity, such as a single-member limited-liability company. The exchanger is responsible for replacing mortgage boot by securing additional debt, equity, or debt and equity that will be required to purchase and improve the replacement property in excess of cash boot. It also is responsible for obtaining property and casualty insurance and for hiring the general contractor to oversee the construction or renovation.

- 3. Finally, the parked property must be acquired as replacement property** at the completion of construction or 180 days from the date the accommodation titleholder parked the property, whichever comes first. To ensure complete tax deferral, the taxpayer must reach the target replacement value (i.e., the total value that equals or exceeds the relinquished property's value) on or before the 180th day. If necessary, this allows the taxpayer to acquire the property in a semi-improved

Leasehold Exchanges

In addition to construction exchanges, property-owners also could use leasehold exchanges. These allow owners to perform improvements on their properties, with some limits.

Construction and leasehold transactions also can be reverse exchanges, in which a replacement property is parked and improved before the property-owner sells the relinquished property. When improvements cannot be completed within the 180-day safe-harbor time frame, it's wise to structure the reverse transaction as a non-safe-harbor exchange.

state. No certificate of occupancy or similar completion confirmation is required.

For example, if a taxpayer sells relinquished property for \$2 million and directs the accommodation titleholder to acquire raw land for \$1 million, improvements of an additional \$1 million must be completed within 180 days to ensure complete tax deferral. Once \$1 million of improvements are complete, the semi-improved, parked property has achieved the target replacement value of \$2 million and may be transferred to the taxpayer to complete the exchange.

This third step can be completed by either deeding the improved property to the taxpayer or, in most instances, by transferring the membership interest in the limited-liability company to the taxpayer.

Debt-financing nuances

Most 1031-exchange transactions include mortgage boot because most investors use

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debt leverage to acquire property. In a forward exchange, the debt element is fairly straightforward. A property-owner simply obtains new financing when acquiring replacement property.

But the debt is structured differently in more-complex transactions in which an accommodation titleholder must be used. This is because the accommodation titleholder, rather than the taxpayer, must acquire and own the property while construction improvements are under way.

When an accommodation titleholder is needed, lenders have options for structuring the debt component of the exchange. These include:

- **Lender loans to the accommodation titleholder.** Because the accommodation titleholder takes title to the parked property, the lender may make a nonrecourse loan. In this case, the accommodation titleholder signs the promissory note and security instrument, and the parked property is pledged as collateral. Because most lenders today require recourse against borrowers, the lender would then look to the taxpayer to guarantee the debt.

This is the most common structure that lenders accept in exchange transactions that require an accommodation titleholder. Should the taxpayer acquire the replacement property by deed transfer, the lender will want to modify the loan documents to reflect the change in collateral ownership. If the exchange is completed by transferring the membership interest in the accommodation

On the Web

For more on 1031 exchanges, see *Scotsman Guide's* October 2009 Q&A with Federation of Exchange Accommodators Past President Hugh Pollard: sctsm.in/3797.

titleholder, a modification typically is not necessary.

- **Lender loans directly to the taxpayer.** A lender sometimes may not be comfortable lending directly to the accommodation titleholder. Often, this is because the lender has an established relationship with the taxpayer, not the accommodation titleholder.

In these instances, the lender may require that the taxpayer pledge assets outside of the parked property or that the taxpayer borrow directly from the lender. This might include borrowing against stock holdings or through a home-equity or business line of credit. The taxpayer would subsequently loan the borrowed amounts to the accommodation titleholder. The accommodation titleholder would execute a nonrecourse note and security instrument and pledge the parked property as collateral for the taxpayer's loan.

- **Hybrid structures.** Sometimes, a lender may consider a hybrid structure

whereby the accommodation titleholder signs the security instrument, the parked property is pledged as collateral and the taxpayer acts as the borrower on the promissory note.

The broker's role

To help their commercial property-investor clients, mortgage brokers must understand the basics of the 1031-exchange process and the applicability of various exchange strategies — including their usefulness to accomplish green objectives. Brokers and their clients also must acknowledge the highly inflexible 180-day timing for completing safe-harbor exchanges. Unexpected delays in the debt-funding process can impact the exchange process negatively and may result in the failure of the exchange.

It also is vital that brokers communicate these issues with the lender to plan accordingly.

Further, having a working knowledge of the various exchange strategies allows brokers to understand the potential complexities surrounding the leverage for the transaction. Brokers who propose these strategies proactively can provide more value to their clients and garner loyalty. ●

Note: This article was written for educational and informational purposes only and should not be construed as legal or accounting advice. Advise your clients to consult an attorney or certified financial planner to determine what is legal and appropriate for their specific situation.