



Using 1031 Exchanges to Clean Up Your Portfolio

By Russell Marsan and Stephen A. Wayner, Esq.

The “green movement” has quickly gone from fad to trend to global initiative. In the United States, corporations as well as commercial and residential property owners are being challenged to find ways to embrace green initiatives in response to demands for greater sustainability, social accountability and profitability.

Guided by the U.S. Green Building Council’s Leadership in Energy and Environmental Design (LEED) certification program, energy efficiency, resource conservation and environmental sustainability are increasingly important factors in maximizing asset value. But, many of today’s commercial buildings are anything but green. Outdated heating, ventilation and air conditioning (HVAC) systems can result in continually increasing operating costs. Antiquated and drafty windows, leaking pipes, old asbestos panels and new patches of mold can create a costly environmental nightmare.

Many investors and businesses saddled with “brown” properties are using a 1031 tax-deferred exchange strategy to quickly divest themselves of environmentally outdated properties and acquire modern, energy-efficient ones.

How does it work?

Under Internal Revenue Service Code Section 1031, a taxpayer can defer payment of capital gains, depreciation recapture and other state taxes on the sale of investment or business property, provided the proceeds are used to purchase replacement property within certain timeframes. To qualify for a safe harbor protection tax deferral, proceeds must be held by a qualified intermediary (QI) between the sale of the relinquished property and the purchase of the replacement property.

For property investors and corporations considering exchanging their investment properties, “going green” offers a host of tangible benefits, including lower operating costs, the ability to attract a higher class of tenants, greater leasing value, a higher cap rate and the potential to increase asset value.

Many property owners also enjoy the personal satisfaction, goodwill and potential positive publicity generated by taking action to improve the environment. For corporations that have identified sustainability and environmental concern as corporate goals, 1031 tax-deferred exchanges deliver immediate results.

Why use a 1031 approach?

Sophisticated property investors have used 1031 tax-deferred exchanges for many years as an effective strategy to preserve wealth and grow assets.

Under a typical 1031 exchange, the owner relinquishes an income-producing property, then identifies and purchases a replacement property of equal or greater value in accordance with strict rules. The owner can defer paying all applicable state income taxes, a 15 percent federal tax on any capital gains and a possible 25 percent recapture on the accelerated depreciation and state taxes. A property owner who plans to go green with the new property may also be eligible for a growing number of federal,

state and local incentives.

An added benefit is that 1031 exchanges also provide flexibility in terms of a real estate investment strategy. An owner can consolidate several holdings and purchase better-performing properties while deferring the tax consequences indefinitely. And 1031 exchanges can be used with virtually any type of business or investment property, including hotels, apartment buildings, motels, shopping centers, warehouses, oil and gas, residential homes and land held for investment.

Cases in point

In 2007, an investment property owner renting three single-family homes with septic tanks in a major metro suburb learned those homes needed a costly connection to municipal water and sewer services. The farsighted owner used a 1031 exchange to relinquish the three properties and rolled all of the profits (including the deferred taxes) into the purchase of a new shopping center.

Recently, Bayview 1031 assisted an investor who purchased a decaying hotel in a rural setting as his replacement property. In this case, the investor used the equity and tax savings gained in the 1031 exchange to turn a “brown” property into a “green” one. He renovated the facility into a modern executive conference lodge and cleaned up a muddy stream running through the property. Today, the property is a popular destination retreat with a much higher valuation.

Creative exchange strategies

Because the green building movement is still in its infancy in the United States, many property investors seeking to capitalize on these benefits may be faced with construction and renovation issues. Fortunately, there are several variations on a traditional 1031 strategy that let an owner develop or build a modern, energy-efficient property and still enjoy potential tax advantages.

One such strategy is a reverse construction exchange. In this case, the taxpayer closes on the purchase of the replacement property and then sells the currently owned property within 180 days. A property investor could also purchase a new property that’s still under construction and enjoy 1031 tax advantages, provided the current value of the new property is equal to or greater than the prior holding at the time of transfer.

For the 1031 investor or corporation using a 1031 exchange strategy, going green offers a win-win proposition: it’s a win for the investor and a win for the community where the property is located.



Russell Marsan is national sales manager and certified exchange specialist with Bayview 1031 and a qualified intermediary for 1031 tax deferred exchanges. Call (530) 755-8355 or e-mail russellmarsan@bayview1031.com.

Stephen A. Wayner, Esq., C.E.S., brings over 35 years of legal and real estate experience to his position as first vice president of Bayview 1031.

