

Green 1031 Exchanges

Investors Go Green, Save Green with 1031 Exchanges

1031

Knowledge

However modest its beginnings may have been, there can be no doubt whatsoever that the “Green Movement” has evolved from fad, to trend, to global initiative. As a result, commercial property owners are feeling increasingly pressed to respond to demands for greater sustainability and social accountability. One way property owners can respond is to examine the environmental standards established by the U.S. Green Building Council’s “Leadership in Energy and Environmental Design” (LEED) program; the LEED program was put in place to encourage and accelerate the adoption of sustainable development and building practices. Given rising energy costs, as well as general public concern about the environment, LEED certification has become a more significant criteria used by buyers and brokers evaluating commercial property.

Sadly, many of today’s commercial buildings are far from “green.” Replacing outdated heating, ventilation and air conditioning systems can involve major capital expenditures and significantly reduce cash flow during the renovation period. However, avoiding necessary environmental renovation imposes heavy costs by itself arising from inefficient electrical systems, inadequate insulation, antiquated single pane windows, leaky pipes, asbestos, mold and compliance with current and future environmental regulations. Fortunately, investors can choose a third option if they don’t wish to either undergo an expensive renovation or persevere with an outdated commercial property: the 1031 exchange. Taxpayers can utilize Section 1031 to exchange out of an environmentally unfriendly property into a modern, energy-efficient commercial property. Who knew §1031 was so green?

GREEN CASES IN POINT

Recently, a taxpayer realized that his three single-family rental properties required a connection to local water and sewer services to mitigate issues with the septic system. Instead of performing the costly renovation, the taxpayer used a 1031 exchange to sell all three rental properties and acquired a newly completed shopping center. In another case, a taxpayer used an “improvement exchange” – i.e. an exchange in which a taxpayer acquires a property which has been constructed according to his or her own specifications – to relinquish an old hotel and acquire an old brownfield which was improved to create an updated and eco-friendly property. The brownfield property was ultimately used as an executive retreat and conference lodge, but a number of green improvements were made, including clean up of a polluted and muddy stream running through the parcel. Presently, the brownfield property is a popular destination where guests regularly catch brown trout in the recently cleaned stream – a great example of the “greening” of America.

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THE FUTURE OF THE GREEN MOVEMENT

The green building movement is still growing in the United States, and most reliable signs indicate that this will continue into the foreseeable future. Green technologies are evolving rapidly and environmental sustainability remains an important issue among investors. Taxpayers seeking to capitalize on the green movement may be faced with construction and renovation issues. Fortunately, there are several 1031 exchange variations that permit a taxpayer to develop or improve a property like in the case discussed in the above brownfield example. One strategy, known as a reverse improvement parking arrangement exchange, permits a taxpayer to acquire a replacement property to be improved before the sale of the relinquished property. Actually, the replacement property is acquired for the taxpayer by an "exchange accommodation titleholder" or "EAT" (an entity created as part of the exchange that is owned by the taxpayer's qualified intermediary). Once the EAT acquires the replacement property, the taxpayer has 180 calendar days to complete the planned improvements, close the sale of the relinquished property and take ownership of the improved replacement property to complete the 1031 exchange. A reverse improvement parking arrangement can be complex, but with proper planning an improvement exchange permits a taxpayer to acquire a building that is in need of improvement (possibly from a seller unwilling to make those improvements) and use the proceeds resulting from the sale of the relinquished property to make the improvements to the replacement property. There are other 1031 exchange variations that permit improvements to be completed on the replacement property that not only defers capital gain taxes, but also produces a greener America.

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