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1031 exchanges maximize equity utilization and leverage during times of tight credit

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Section 1031 of the Internal Revenue Code offers significant advantages for taxpayers engaging in commercial real estate transactions. Simply put, it permits an owner to defer capital gain on the exchange of property that has been held for productive use in a trade or business or for investment by providing an exception to the general tax rule requiring the current recognition of gain (or loss) upon the sale of property.

By completing an exchange, taxpayers may defer their taxes. But what are the economic implications of using 1031? Why is it a particularly effective tool during times of tight credit? How can it hold down the cost of borrowing? And how can it maximize leverage for future acquisitions?

We can answer these questions by using a simple example (ignoring brokerage commissions, fees, other transaction costs, and state taxes). Let's say that Acme USA Corporation acquired Massachusetts industrial property some years ago for $500,000 (the original cost basis). Since then, $320,000 worth of depreciation has resulted in a current adjusted basis of $180,000. Acme put the building up for sale last December, and its broker recently found a buyer willing to pay $980,000. Thus, Acme's anticipated gain from the sale is $800,000 (sales price less adjusted basis). Acme has no mortgage to pay off, so cash proceeds from the closing are $980,000. Acme plans on putting away $280,000 of the proceeds for federal taxes that will be owed as a result of the gain, based on Acme's corporate income tax rate of 35%. It will use the balance of the proceeds, $700,000, to buy an industrial office/warehouse facility in Rhode Island.

Acme can buy the new warehouse for $2 million. Since the company is bringing $700,000 to the second closing, it arranges an acquisition loan of $1.3 million. It's a loan amount that Acme's CFO would prefer to reduce.

But note how the economics change if the company does the deal as part of an exchange. Acme's capital gain stays $800,000. The closing agent wires all of the equity -- in this case, $980,000 in sale proceeds -- to the company's Qualified Intermediary (QI) for Section 1031 exchanges. A few months later, the QI wires the $980,000 into the warehouse closing, allowing Acme to use all of the equity from the first closing to acquire the warehouse as Section 1031 Replacement Property. Acme's CFO is happy. The loan amount is reduced by 20%, to a more palatable $1.02 million. Acme was able to take the cash it would have set aside to pay taxes and use that equity towards the acquisition cost.

A different scenario: Acme wants to buy a mixed-use building adjacent to the warehouse for future expansion (cost: $1,500,000), and is willing to take a larger loan to do it. But there's a problem: Acme's lender has a maximum loan-to-value (LTV) requirement of 75% and won't budge. Recall that, without an exchange, the company's net proceeds after taxes are $700,000. So, with the loan, Acme can buy property totaling $2,800,000. But the aggregate cost of the warehouse and mixed-use properties is $3.5 million. However, using a Section 1031 exchange, the extra equity of $280,000 allows Acme to leverage into a larger loan. Using its original $980,000 equity and the higher loan, Acme could acquire total property worth almost $4 million -- enough to buy both properties.

A word of caution, however. In order for the 1031 exchange to be completely successful and not have any taxable component, the taxpayer must not receive "boot." If Acme were to receive some of the proceeds at the closing table, or from the QI after its exchange is over, then Acme will have received "boot." And then it would be taxed on the lesser of its taxable boot or its potential taxable gain. There are different types of boot , either cash or mortgage boot, but the general rule is that the taxpayer should "trade up" (or at least stay equal) in both property value and equity to avoid taxable boot.

And the $800,000 gain is only deferred. Acme will pay taxes on that gain later, when the warehouse is sold in an otherwise taxable transaction. Also, because carry-over basis is utilized in 1031 exchanges, the stream of depreciation that would have otherwise been available from the replacement property will be reduced. In the final analysis, however, during these times of tight credit and scarce cash when every dollar counts, section 1031 can be just what the doctor ordered.

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