LAWS
EXPA

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Businesses situated in owner-occupied buildings often face the task of selling an existing facility and relocating to a new facility to accommodate business growth. As if finding a new location isn't difficult enough, there are significant tax implications if the relocation transaction is not structured properly.

The existing facility may have been built or purchased years ago and may have an extremely low adjusted tax basis, resulting in a substantial taxable capital gain upon the sale. If the sale of the property will result in a significant capital gain, it is essential to structure the transaction to take full advantage of the tax deferred exchange rules promulgated under Section 1031 of the Internal Revenue Code.

A 1031 exchange transaction is almost never a simultaneous transaction. However, the rules require that a 1031 exchange be completed within 180 days after the sale of the existing facility.

Let's take the example of a company that owns a 100,000 square foot distribution facility and has outgrown it. The company wishes to build or buy a new 500,000 square foot state-of-the-art distribution center. The goal is to sell the existing property and to use the sale proceeds to purchase the replacement property, thus deferring any taxable gain on the sale of the existing property.

If the 500,000 square foot building had already been built, the exchange process would be fairly straightforward. The taxpayer would sell the facility and use the sale proceeds held by a "qualified intermediary" to acquire the new property, complying with the 180-day completion period of the exchange requirements. Assuming compliance with all other 1031 exchange requirements, the capital gain on the sale of existing facility would be deferred.

However, what if, due to certain timing circumstances, the 500,000 square foot building had to be purchased *before* the sale of the existing facility? Moreover, what if the purchase was of land only, requiring the taxpayer to construct the new building *before* selling the existing facility?

Build–to-Suit Exchanges

In this example, the taxpayer has identified a land parcel on which to build the new facility. While land is a suitable like-kind property, the sale proceeds from the sale of the existing facility may exceed the cost of the land. Any excess sale proceeds not used in the exchange or “Boot” will be taxable as a gain. Unfortunately, the excess proceeds or Boot cannot be used toward construction costs. Any improvements made on property after it is owned by the taxpayer are not considered “like-kind.”

Accordingly, the taxpayer needs to structure a transaction to acquire and “trade into” the new facility after the improvements have been either partially or substantially completed and within the required 180-day exchange period. Note that the timing of architectural plans, engineering, zoning approvals, and permitting for the construction project must be considered. Having these items in process or completed is essential to meeting the 1031 timing requirements.

There are a number of ways to accomplish a build-to-suit exchange in which a taxpayer can construct a new facility, “trade into” the new facility and defer the gain.

Seller Undertakes Construction

One possibility is to have the seller of the replacement property undertake the construction of the new facility. The acquisition contract would contain the construction details and the purchase price would include all construction costs. Partial payments from the sale of the existing property could be used to make progress payments toward the purchase price.

Unfortunately, it is very unlikely that a seller would agree to act as a developer and take on the construction risk. If financing for acquisition/construction is needed, it is often difficult to convince a lender to provide construction financing to an unrelated third party on property that is not yet owned by the taxpayer.

This approach works best in the case of a seller making pre-closing improvements such as a new roof, truck docks, parking lot improvements, and electrical and lighting upgrades to an existing building. By increasing the purchase price accordingly, a taxpayer can utilize additional sale proceeds in the exchange.

General Contractor Builds to Suit

Another possibility is to find a general contractor who is willing to acquire the property and perform the construction. The contractor would need to utilize the taxpayer’s funds or loan proceeds to fund the land acquisition and construction of the improvements. Given that the contractor would either directly or indirectly own the property until the construction has been completed, proper safeguards are critical to this approach.

A build-to-suit construction contract may be entered into between the taxpayer and the developer to provide for the desired construction. As noted above, the closing to purchase the new building would need to be completed within 180 days after selling the existing facility. In some cases, the new facility may only be partially completed at the time of closing. However, that circumstance would not be an impediment, so long as the 1031 exchange funds are utilized to purchase the property at its partially completed value.

Reverse Exchange

A common way to accomplish the build-to-suit transaction is by structuring a 1031 “reverse exchange.” This technique allows the taxpayer to retain the existing facility during the construction process on the new facility. The reverse exchange employs an Exchange Accommodation Titleholder (EAT) who acts as titleholder for the replacement property and undertakes the construction. Although the EAT is the owner of the property, the taxpayer typically leases the property from the EAT and therefore has complete control over the property and the construction project. It is important that the taxpayer is able to finance the cost of the acquisition and construction, since in this structure the sale proceeds will not be available until the existing facility is sold.

During the construction project, construction loan financing for the benefit of the EAT – arranged and guaranteed by the taxpayer from a third-party lender – can be utilized to fund the construction of the new facility. Upon the sale of the existing facility, the taxpayer would “trade into” the completed replacement property using the sale proceeds from the sale of the existing facility. The taxpayer can acquire its interest in the replacement property by a deed or simply by taking an assignment of the EAT’s entire membership interest in the single purpose entity created to hold title to the replacement property. At that time, the proceeds to the EAT will be used for the repayment of the construction financing. The 1031 Exchange timing rules are still applicable to the reverse exchange. The taxpayer must sell the existing facility within 180 days after the EAT acquires the replacement property.

When there are tax consequences involved, it is essential to plan in advance for a facility relocation. The specific recommended approach will depend on the particular facts and circumstances of the transaction.