

**The Opportunity: Utilizing or Financing non safe harbor “Extended Construction Exchanges”**

Real Estate management firms and privately owned (non-publicly traded) companies of all sizes are eligible to utilize 1031 exchanges to dispose of matured properties and replace them in a tax-advantaged manner. The tax savings can be many millions of dollars. However when the company is better served by building, renovating or improving their own replacement property, they must hire a specialist 1031 firm (the Exchange Accommodator) to structure and manage for them a Non-Safe Harbor construction exchange. Assuming 1-2 year projects, the accepted method is for the company to give up the ownership of the property being developed to the specialist exchange firm in a transparent manner, utilizing a bankruptcy remote LLC.

The client company arranges project management. It will typically provide 50% of the land and improvement costs, and a 1<sup>st</sup> lien lender comes in with 40-45%, but to be in compliance with the strict procedures of this exchange strategy, neither can provide funds for the final 5-10% of “equity“. This has to be contributed by the 1031 specialist firm (Exchange Accommodator), via

the LLC they set up so they can own (“risks and rewards”) and control the properties within each exchange. The Exchange Accommodator will borrow the “equity funding” money using the ownership of the entire property and improvements as collateral, with a triple-net-lease from the client for monthly ROI payments and routine expenses.

Our group supplies the architecture and process to allow for exchanges with longer duration than the 180 days of a routine safe harbor exchange. A stream of transactions is anticipated. We seek a real estate financing firm with the capability to either bid on the construction loan and/or line up the higher-rate “equity” funding. For the later, the documents supporting the transaction are similar to most features of a mezzanine loan, but with much lower LTC plus the short duration of a construction loan. Diversified Real Estate firms most certainly can utilize these tax deferred exchanges for their own portfolio or for the benefit of their clients and affiliates.

**Title, Ownership, Funding and Exit Strategy**

The Exchange Accommodator firm (EA) for this service is highly specialized, and works with arguably the top tax counsel in this field. The 1031 exchange strategy is established and the EA will form a special purpose entity (SPE) as a holding company for the land and improvements. The SPE is a customized Bankruptcy Remote LLC created under a binding contract which creates the Exchange Cooperation Titleholder that will take title to the property. A Bank, Private lender or investor can arrange the “equity” funding for this transaction to be invested via the Exchange Cooperation Titleholder (ECT) and is assigned ownership of the LLC. The Exchange Accommodator is the managing partner of the ECT, and by contract acts to oversee the accounting & cash outlays for the entire non safe harbor construction exchange for its duration. As a professional service provider, the EA is given exceptionally strong provisions by the exchange documents to protect the equity financing (and the 1st lien financing). The contract with the Exchangor (client) incorporates terms of the lease payments by

the client and provides remedies for any delays or problems. Overall construction delays past the intended loan duration could trigger the remedy of escalated rent specifically to pay back the “equity” financing plus ROI in short order (12 months).

By contract, a default can be remedied by the ECT’s right to control or sell the entire property, pay off the construction loan and protect your loan using the client’s cash contribution as a buffer. This is unlikely, as the client already has other property(s) targeted for sale, the point of the exchange being to shelter taxes by directly applying the proceeds of their sale to the new property and buying out the ECT and therefore paying off your loan. Client quality is expected to be very high, and a feasibility study supports each exchange. A review of the documents will show that client bankruptcy, with the resulting property sale netting less than 50% of costs, is the only way that our “equity” funding participant can lose principal.

**Typical Financing Structures**

We typically seek 5% to 10% LTC in “equity” financing per deal, with corresponding construction loans at 40-45% LTC. Project sizes will vary, with feasibility studies establishing motive (tax deferral) and exit strategy (pay off financing and keep the property). There is a NNN lease payable to the Exchange Accommodator, which as managing member and tax preparer for the exchange, monitors all cash flow for entire transaction life. The NNN lease provides for monthly ROI payments made on the equity financing. At an agreed-on date the proceeds from the sale of the client’s old property is brought in and applied to the transaction. By contractual agreement your “equity” funding is first to be paid off. The construction loan is either retired or replaced with permanent financing. As explained above if the loan extends beyond the original agreed on period, the client’s triple-net-lease has an escalation clause in place to provide the cash flow to pay off your equity funding very rapidly. Since your “equity” funding is the ECT’s contribution, the ultimate risk is quite reasonable since the ECT would have the option of controlling or selling the property if need be, owner equity included, to help secure your fixed ROI and principal.

Non-public corporations, individuals, LLC’s, Trusts and other business entities are eligible to use this straightforward tax strategy. The market potential of these transactions, as designed by this exchange specialist in particular, is quite large. The architecture of this “Extended 1031 Exchange” strategy allows for three distinct uses:

This is an efficient structure to allow taxpaying entities to enjoy the significant financial benefits of the 1031 exchange without the restrictive 180 day limitation. Therefore, timely buying opportunities can be improved by the ability to use the tax liability of mature & saleable portfolio properties to pay down debt or replace owner equity. The extra time gives confidence that one or more properties can be

successfully chosen, prepared, sold and applied to the exchange.

This 1031 exchange structure is particularly useful as a means to include large-scale renovation or construction projects as financial beneficiaries of the deferred-tax infusion. Coordinating the sale of profitable or mature properties to within several months of the completion date of the new project can retire 15% or more of the construction costs via deferral of capital gains, recapture and State taxes normally due on the sale of the sold properties.

In addition, should any taxpaying entity find itself in the position of having started a 180 day reverse exchange but it appears the old (relinquished) property will not sell in time, you can confidently refer them to our extended 1031 exchange for a fast and effective solution. This application is aptly nicknamed the “Save the Deal” strategy.

All three strategies offer the opportunity for short-term placement of equity funding in an attractive risk/return ratio. Strict adherence to custom-designed contracts and document templates gives continuity to financing. For the “equity” funding, these documents incorporate some features consistent with a mezzanine loan, though obviously in a lower risk scenario.

The “Save the Deal” strategy also requires the small “equity” infusion. It will typically involve little or no 1st lien debt during the exchange, but may well represent a permanent mortgage opportunity at the conclusion of the exchange.

This is a very exclusive field, with only a small handful of firms having the expertise and organization to offer these exchanges. Your participation may be on multiple fronts, from financing, to tax management for your own portfolio, as well as offering a referred customer service that can save large clients millions of dollars in US taxes.

For additional information and to speak with the Exchange Accommodator or the Tax Counsel directly, please contact me at the phone or email address below.

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