

Capital Markets

Bankruptcy remote entities and 1031 exchanges

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You've just sold your old property in a 1031 exchange for \$500,000. You've found the perfect new property, and it's a steal at \$2 million. Your exchange intermediary is holding \$500,000 for you, and your banker is very receptive to your loan request for the balance of \$1.5 million. He giving you a break on the loan fee, and the interest rate is better than you hoped to get. There are no structural problems, and a few minor cosmetic changes should allow you to raise the rent a little, giving you a very respectable cash flow. Life is great – until the call...

At first it didn't seem that big a deal; the loan committee approved the loan, but requires that the property be held in what they are calling a bankruptcy remote entity. They want the property held in a separate entity, all by itself. That didn't seem unreasonable, so you called your attorney and hand him set up a corporation to own the property so that you would be protected from liability as well.

Two days before the closing you get the call. It your exchange intermediary, and he says that the title company is telling him that you plan to take title to the property as XYZ Corporation. He informs you that one of the requirements of a 1031 exchange is that you must take title to the new property exactly as you held title to the old property. Since the old property was in

your name, your exchange will be disallowed if you take title through the corporation. The tax would be almost \$100,000, so you don't want that to happen.

You call your banker and explain the problem. He can't help you; it a requirement of the loan. You suggest that you take title in your name and then immediately transfer the property to the corporation. He says he'll check and call you back. You immediately call the intermediary to tell him you've solved the problem. He tells you that your plan will be treated by the IRS as if the corporation were the buyer anyway – resulting in a disallowance of your exchange.

You've already got a headache when you call your real estate broker to tell him you need to extend the closing so you and figure this out. He tells you the seller has two backup offers and will not extend the closing. In fact, since both of the offers are for more money than yours, the seller's hoping you don't close. And worse - if you don't close he'll keep your earnest money. You take two aspirin.

Your banker calls back. You have to take title in a single asset entity or they will not make the loan. You take two more aspirin.

Sound familiar? This happens a lot – but there is a solution. You CAN make this work.

The reason your lender wants the property in a bank-

ruptcy remote (or single asset) entity is to protect them of one of your other properties gets into trouble. Without this protection, if another property has financial difficulties you might use the cash flow of the new building to save the other one, thereby jeopardizing the new loan. If you file for bankruptcy protection, the bankruptcy court could pull the cash flow off the new building to pay other creditors.

Any of these type of reasons could put the loan on the

returns filed for the LLC.

When you follow this procedure, the LLC is ignored by the IRS and they treat you as the buyer of the new property. In this way you comply with the requirements of Section 1031 because you sold the old property and you through your single-member LLC, are the buyer of the new property. And the bank is happy because they have a single asset, bankruptcy remote entity.

You call your attorney to have him set up the LLC. You

A bankruptcy remote entity can be integrated into a 1031 exchange through the use of a limited liability company.

new building at risk. To protect themselves from this, the lender wants this property in its own entity, separate from all of your other property. Their desire for protection seems at odds with the requirements of a 1031 exchange. But it's not. There is a solution.

You solve the problem by using an LLC, a limited liability company, instead of a corporation or partnership. This LLC must have only a "single member" – you. The IRS has a procedure call "check the box," where you check a box on your individual tax return which means you elect to ignore the LLC when you file your individual income tax return. Your CPA will know how to do this. All of the income and expense from the property is then reported in your individual return, and on income tax

call the lender and explain what is happening so that he can change the name of the borrower on the loan documents to the LLC. You call the title company and the exchange intermediary so that they can fix their documents. Your call your real estate agent and tell him you're ready to close. Your last call is to your CPA to make sure that he "checks the box" for the LLC.

Your headache is gone. Life is great again.

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