

Deposits In An Exchange

Handling Earnest Money Deposits In An Exchange

1031

Knowledge

Most offers to purchase real estate are accompanied by the buyer's delivery of a check to the seller typically referred to as an earnest money deposit. Depending on the terms of the purchase agreement, the deposit may be refundable or non-refundable. In most cases, the delivery of the deposit is refundable and merely serves as evidence of the buyer's intent to purchase a property.

In a tax-deferred exchange under Internal Revenue Code Section 1031, the seller/taxpayer is prohibited from receiving the proceeds from the sale of the relinquished property. A taxpayer is "in receipt" of sale proceeds if ". . . *the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given.*"

As a result of the foregoing rules, taxpayers are rightfully concerned about the tax consequences resulting from their receipt of a deposit from a buyer or the payment of a deposit to a seller for the acquisition of replacement property. Some common questions asked regarding the handling of deposits in an exchange are discussed below:

If a taxpayer/seller of an investment property is planning to engage in a 1031 exchange, can the taxpayer accept a deposit and still obtain full tax deferral? The answer is usually, yes. First, the question of whether the taxpayer is in receipt of the sale proceeds is determined at the time ownership is transferred from the seller to the buyer (usually at the time of the closing). Thus, if the taxpayer enters into an exchange agreement before the closing, as required when engaging in a 1031 exchange, and thereafter deposits the earnest money funds with the qualified intermediary (QI) or the closing agent before the closing occurs, the receipt of the deposit should not be treated as the receipt of sale proceeds. On the other hand, if the taxpayer kept the deposit through the closing, he/she would be in receipt of proceeds from the sale. In this case, the deposit would constitute boot in the exchange and thus taxable to the extent there is a capital gain.

Can 1031 proceeds be used to make a deposit for the purchase of replacement property? Yes. The QI can advance funds for the deposit once the contract has been assigned through the exchange documents making the QI the purchaser of the replacement property.

Can the taxpayer enter into a contract on replacement property before entering into a contract on their relinquished property? Yes. However, it is important to close the transaction on the relinquished property prior to purchasing the replacement property in order to avoid a reverse exchange parking arrangement situation.

Can a taxpayer be reimbursed for a deposit paid on replacement property? A QI cannot make a direct reimbursement of a deposit to the taxpayer. However, a QI can replace a taxpayer's deposit held by a closing agent with exchange proceeds for reimbursement at closing.

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