

DEPOSITS IN AN EXCHANGE

"HANDLING EARNEST MONEY DEPOSITS IN AN EXCHANGE"



Compliments of

Most offers to purchase real estate are accompanied by the Buyer's delivery of a check to the Seller generally referred to as an "Earnest Money Deposit". Depending on the terms of the purchase agreement, the earnest money deposit may be refundable or non-refundable. In most cases, the delivery of the earnest money 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, however, the Seller (Exchanger) is generally prohibited from receiving the proceeds from the sale of the relinquished property. An Exchanger receives 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, Exchangers are rightfully concerned about the tax consequences resulting from their receipt of an earnest money deposit or the payment of an earnest money deposit to a Seller in connection with the acquisition of replacement property. Some of the typical questions that Asset Preservation receives are discussed below:

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

Can an Exchanger pay an earnest money deposit to a Seller of replacement property? Yes. There are two ways to accomplish this within a tax deferred exchange. If the Qualified Intermediary is holding exchange funds from the sale of the Exchanger's relinquished property, the deposit can be wire transferred directly to the Closing Agent or Seller for the Exchanger after the replacement property exchange agreement has been fully executed by the Exchanger. Alternatively, the Exchanger can pay the earnest money directly to the Closing Agent or Seller from their own funds and get reimbursed their deposit at the closing without creating a taxable event. The Exchanger may enter into contract on the replacement property before entering into contract on their relinquished property, but it is important to close on the relinquished property prior to purchasing the replacement property in order to avoid a "Reverse Exchange" situation.

Can an Exchanger get reimbursed for their earnest money deposit paid for the replacement property? Yes. Assuming that the Exchanger has paid the earnest money deposit from their own funds, the Qualified Intermediary may direct the closing agent to include an item on the closing statement evidencing the return of earnest money funds to the buyer such as "Refund of Earnest Money to Buyer". The Qualified Intermediary would then transfer funds to the closing agent in an amount sufficient to reimburse the Exchanger.



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