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Getting your money out during a 1031 exchange

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One of the more troublesome calls we receive as a Qualified Intermediary (QI) is when an investor has sold property and received the net proceeds at the closing, and later decides to participate in an IRC Section 1031 Exchange. Or worse yet, the investor has already sold property as part of an exchange, the funds have been wired to the QI, and at some future date calls to withdraw money out of the exchange for other than the purchase of like-kind property. The rules regarding exchange funds are quite specific, and often misunderstood by investors.

The Treasury Regulations establish four "safe harbors" under Section 1031, allowing the taxpayer to avoid actual or constructive receipt of funds for purposes of completing a tax deferred exchange. One of these is use of a Qualified Intermediary to limit the Exchanger's (Taxpayer's) right to "receive, pledge, borrow or otherwise obtain the benefits of money or other property" before the end of the 180 day time deadline, except as permitted under a specific section referred to as the (G)(6) Restrictions.

Basically, the Exchanger, or anyone related to or having done business with them in the past 2 years cannot receive or control the funds during the exchange. The Qualified Intermediary is established prior to the sale through an Exchange Agreement and assigns into the contract for the transfer of property. The QI receives the net proceeds once ordinary closing costs are paid, such as commissions, recording fees, transfer taxes, title insurance premiums, etc.

So when is an investor able to take money out of a 1031 Exchange? Prior to the sale, the seller may decide to keep some money at the closing, possibly to pay off other debt, college tuition, buy a car, etc. These cash proceeds received are considered "Boot" - gain will be recognized and taxes due on that amount. This does not void the exchange altogether, but rather is considered a partial exchange, where the remaining funds are wired to the QI to be held for purchase of replacement property.

Careful consideration should be taken before deciding to receive proceeds directly. If later, for example, during the identification period the taxpayer finds additional replacement properties or property of significantly greater value than had been anticipated, and those funds received are now needed to roll into the purchase, the taxpayer will not receive tax deferral treatment on that amount since it has already been taken as Boot. If the money is not needed immediately, the exchanger may consult with their tax advisor as to whether it may be a better financial decision to roll all the proceeds through the exchange for the full tax deferral, and refinance to pull cash out at a later date.

Once the closing has occurred and the Intermediary has received the proceeds, the Exchanger cannot pull cash from the account at will. Under the Code provisions, the Intermediary must hold funds for at least 45 days to allow the Exchanger to identify replacement property. If no property has been identified in the 45 Day period, the exchange is terminated and the proceeds are returned to the taxpayer - taxes will be due as if an exchange never took place.

If the Exchanger accurately identifies property within the 45 Day Identification Period, the QI must hold the funds until Day 180, in order for the Exchanger to purchase said property. This taxpayer cannot simply decide mid-way through the process to skip the purchase and take the proceeds from the exchange account. However, if the planned purchase(s) fails to close by Day 180, the exchange is over, proceeds are returned to the taxpayer and taxes will be due.

Another "cash-out" scenario provides that if the Exchanger has properly identified replacement property and has closed on all of the property for which he is entitled under the Agreement, and it is past Day 45, the Exchanger has the right to receive any remaining proceeds in the exchange account, even if it is prior to the end of the 180 Day Exchange Period.

Keep in mind there is an avenue to be able to use excess funds for improvements to new replacement property, but to be part of the tax deferral such improvements must be made within 180 days of the sale closing and prior to the taxpayer taking title to the property. This is referred to as an Improvement Exchange, which carries its own set of regulations I will save for a future articleâ€¦

These safe harbor guidelines are in place to protect the Taxpayer from actual or constructive receipt of the proceeds during an exchange. Those quoting incorrect information or willing to bend the rules on exchange funds to accommodate their client will taint the entire transaction and cost the taxpayer any possible opportunity for tax deferral treatment.

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