

Handling of Earnest Money during a 1031 Exchange

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1031 exchanges are a common part of many commercial real estate sale transactions. The ability of a seller of real estate to avoid capital gains tax is certainly an attractive reason to structure a sale into an exchange. To complete an exchange, the seller cannot sell the property outright. The seller or "taxpayer" must purchase another piece of property in order to complete their exchange. The compliance with certain procedural requirements are necessary in order for an exchange to be valid. One of the critical components of those requirements is the restriction on the taxpayer's ability to take receipt of the proceeds funds from the relinquished property sale. A taxpayer will hire an exchange company to act as qualified intermediary to facilitate the exchange and to hold those proceeds funds during the exchange process.

This restriction on the taxpayer's receipt of funds during an exchange often gives rise to the question of what to do with earnest money payments. Earnest money is usually required as part of both the taxpayer's relinquished



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property and replacement property transactions.

Relinquished property

Typically, when a buyer and seller/taxpayer enter into a purchase agreement an earnest money deposit is required as part of that agreement. The buyer is required to pay this money as a show of good faith in the transaction. Those funds are held in various places dependant on the agreement of the parties.

The usual options for holding of the funds are the real estate broker, a title company or even the taxpayer. The question that arises is: Do any of these options cause taxation of these funds due to receipt or constructive receipt by the taxpayer?

There is not clear guidance on this issue from the IRS. Some commentators note the risk of having any party other than the exchange company hold these funds for fear of the receipt rules, particularly if the taxpayer is holding the funds directly. However, the commonly held opinion is that the funds can be held by another party such as the broker, attorney or title company and this will not run afoul of the receipt rules, as long as, the funds are deposited at the time of closing with the closing agent and run through the closing wherein proceeds will be delivered directly to the exchange company. Under that view, even the taxpayer could hold the funds, however, that is the riskier option.

The rationale for this view is that the earnest money funds are held under a purchase agreement or other escrow agreement which have terms and conditions that must be satisfied before either party can claim ownership of those funds. Thus, the funds are not

received by the taxpayer. An additional rationale is that no taxable event has occurred and those funds are not taxable gain until title is transferred by the taxpayer at closing.

Replacement property

To complete the exchange, a taxpayer needs to purchase replacement property. Now playing the role of the buyer, the taxpayer will be required to make an earnest money deposit upon signing a purchase agreement. Often the taxpayer desires to use the exchange funds, now held by the intermediary, to pay that earnest money. Exchange commentators are in greater agreement on how to accomplish this without running afoul of the receipt rules. It is required that the purchase agreement be assigned to the intermediary and that the funds are held under agreement that the funds will be returned to the intermediary should the deal fall through. That way the taxpayer will not have control over the funds. A broker or title company can then hold those funds.

Additionally, payment by the taxpayer directly of the earnest money (instead of from the funds held by the intermediary) doesn't cause an issue. A taxpayer can always add funds to an exchange transaction. If needed, the taxpayer can receive those funds back upon closing of the replacement property should there be enough exchange funds to complete the purchase.

If documented and handled correctly, the flow of earnest money related to real estate transactions involving a taxpayer completing a 1031 exchange can be completed without adverse tax consequences.