



First American Exchange

A QUALIFIED 1031 EXCHANGE INTERMEDIARY

WARNING! RESTRICTIONS ON RECEIVING CASH IN A 1031 EXCHANGE

Tax deferred exchanges under Section 1031 of the Internal Revenue Code are a great tool for deferring gain on the sale of investment property; however, investors can reap these benefits only if the exchange is structured properly. One requirement for a properly structured exchange involves limitations on when an investor can access funds. For example, once an investor sets up an exchange and the intermediary sells the relinquished property, there are restrictions on the investor's access to the proceeds from the sale of that property. These restrictions are very important to understand and plan for.

Under the Section 1031 exchange rules, a neutral third party must hold the proceeds from the sale of the relinquished property and use them to acquire the replacement property. This is typically accomplished through an intermediary such as First American Exchange. Although an intermediary performs services that can cause it to be treated as if it were the agent of its client rather than a neutral third party, federal regulations state that an intermediary won't be considered an agent if the exchange agreement between the intermediary and the investor expressly limits the investor's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by the intermediary during the exchange period. This restriction on the use of the exchange funds is important in achieving tax deferral for the client, as failure to follow these federal rules may ruin an otherwise valid exchange.

The federal tax regulations (Section 1.1031(k)-1(g)(6)) permit the intermediary to deliver the money to the investor as follows:

- If the investor has not identified replacement property during the 45-day identification period, the investor may receive the funds as of the 46th day.
- If the investor has identified replacement property, the investor may receive the funds at the end of the 180-day exchange period.
- There are two conditions that may permit the investor to receive the funds sooner than the 181st day, even if the investor has identified replacement property. First, the investor may receive the funds as soon as the investor has acquired all replacement property to which he is entitled under the exchange agreement, i.e., everything the investor has identified. If the investor identifies multiple properties, the intermediary should retain the excess funds until the sooner of when all identified properties are acquired or the 181st day.
- Another condition may permit the investor to get control of his funds before the 181st day, but it is very limited. The regulations say that if a material and substantial contingency occurs that relates to the exchange, is provided for in writing and is beyond the control of the investor and any disqualified person other than the seller, then the funds may be delivered to the investor before the 181st day. Although this regulation appears to give the investor more leeway, the IRS has ruled otherwise. The IRS has stated that a "material and

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substantial contingency” occurs when the event is truly out of the control of the investor, such as where the property is destroyed in a fire or condemned, or where a zoning change request which was a condition of acquiring the property was denied, or something substantially similar. These are very limited reasons which may permit an intermediary to release the funds early.

What does this mean for an investor considering a tax deferred exchange? It is important to plan for the possibility that exchange funds may not be available until the 181st day, if the investor identifies multiple properties and only acquires some of them, or even if the investor is unable to acquire any identified properties and therefore has a failed exchange. In both of these instances, the intermediary is supposed to hold the funds until the end of the exchange period. In addition, even if an investor does not identify any properties, the intermediary must hold the funds from the sale of the relinquished property until the end of the 45-day identification period.

These rulings underscore the importance of carefully planning your exchange. Some practical tips include:

- If you know you would like to use only a portion of the equity from a relinquished property, have escrow transfer directly to you the portion that won't be a part of the exchange, with only the balance going to the intermediary. If you do this, you will pay tax on the amount you receive, and in California the escrow agent will withhold 3 1/3% of it prior to sending it to you, but you will have your money immediately.

- If you have identified properties but decide not to do an exchange, and you are within your 45-day identification period, revoke your identification and you should be able to receive the money on the 46th day, rather than on the 181st day.
- You can also indicate on your identification form that you intend to buy only some of the properties identified. Most intermediaries will release the funds to you once you acquire the number of properties you have indicated, but the drawback is that you may not be entitled to exchange into more than the number of properties indicated, even if they are on the identification form. For example, if you identify three properties and indicate you intend to acquire one of the three, you may be able to get the balance of your funds once one property is acquired, but you may not be able to acquire the other two properties if you change your mind during the exchange. Because this point is somewhat unclear in the tax code, you should consult with your own tax advisor before preparing your identification form in this manner.

Planning your exchange will help you have a successful tax-deferred transaction with no surprises. Please contact us at First American Exchange if you need further clarification.

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