WITHHOLDING ISSUES IN A 1031 EXCHANGE

Withholding of exchange funds required by either taxing authorities or by the terms of the Relinquished Property sale agreement can be a problem for the exchange.

A basic problem: The exchange proceeds, including the withheld funds, must be used to purchase Replacement Property within the time period required under Section 1031. This will generally be 180 days after closing of the Relinquished Property.

A basic question: How many dollars will be tied up and for how long?

The bigger the amount being withheld and the more time that amount is withheld, the worse it is for the exchange.

If it appears that the withheld funds will be available in plenty of time to purchase the Replacement Property, the withholding may create very few problems for the exchange. The exchange agreement and escrow instructions should provide that the withheld funds will be released promptly to the Facilitator and be used as part of the exchange credit to purchase Replacement Property.

If the withheld funds **cannot** be made available to the Facilitator in time to purchase the Replacement Property, there are basically two options:

1. **Throw in the towel.** Don't include all or some of the withheld funds in the exchange. The exchange agreement and escrow instructions would "carve out" that portion of the withheld funds from the exchange credit.

2. **Fund the amount to be withheld with outside funds from the Exchangor.** The Exchangor would provide some or all of the withheld fund amount from the Exchangor's outside dollars. This amount would be deposited into the Relinquished Property closing escrow by the Exchangor. The exchange agreement and escrow instructions would provide that the entire exchange credit (now undiminished by the withheld amount) would be released to the Facilitator.

Example: Dave, Sally, and Joe equally and jointly own investment property as Tenants in Common. A Due Diligence investigation determined that they do not hold the property as a Partnership. Dave wants to do an exchange for his 1/3rd. Sally and Joe want their money outright.

The purchase and sale agreement on the Relinquished Property requires that the property be rezoned with two years from the date of closing or the price will be reduced by $600,000 from $6,000,000 to $5,400,000. The Buyer will diligently pursue the rezoning and pay the expenses of rezoning.

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The purchase and sale agreement further provides that the Buyer will fund the full $6,000,000 at closing but that the $600,000 will be held in an interest bearing escrow account until:

The property is rezoned at which time the $600,000 plus interest will be released to Dave, Joe and Sally, or;
Two years passes from the date of closing without rezone at which time the $600,000 plus interest will be released to the Buyer.

After discussion with Dave, it is clear that there can be no assurance that the rezone will be accomplished within 180 days. It is also clear from the discussion with Dave that he thinks the rezone will eventually be accomplished. Dave is adamant that he does not want to pay tax on $200,000 which is his 1/3 share of the $600,000 being withheld.

Dave agrees to fund $200,000 at closing from outside funds so that the Buyer's $200,000 can be released to the Facilitator at closing. The exchange agreement provides that Dave's exchange credit (now not decreased by the $200,000 holdback) will be released to Dave's Facilitator.

The escrow instructions and Settlement Statement (preferably a separate Settlement Statement for Dave) has to be tailored to reflect:

1. Dave is funding $200,000 for his share of the holdback.
2. The Buyer's $200,000 for Dave's share of the holdback is being released to Dave's Facilitator.

By handling the transaction in this fashion, Dave's exchange credit is not being reduced by the holdback and is intact to buy Replacement Property.

It may be possible to take a "wait and see" approach. Some time after closing, the Exchangor determines the withheld funds will not be released in time to buy Replacement Property.

It may be possible for the Exchangor to fund the withheld amount from outside dollars after closing. The success of this "wait and see" approach may require that the exchange agreement provided for the possibility of the Exchangor later funding the withheld amount. The success of the "wait and see" approach would also depend on the willingness of the party holding the withheld amount to accept the Exchangor's outside funds and release the original withheld amount to the Facilitator. Another alternative would be to convince the party holding the withheld amount to accept a letter of credit or other collateral in order to release funds.

Careful advance planning with the Exchangor is critical when there will be withholding or holdback of funds on the sale of the Relinquished Property.