Closing Costs

Understanding Exchange Expenses in an Exchange Transaction

1031 Knowledge

In order to obtain complete deferral of capital gain taxes in an exchange otherwise meeting the requirements of Internal Revenue Code Section 1031, a taxpayer is generally required to reinvest *all* net sale proceeds generated by the sale of relinquished property in like-kind replacement property within the applicable exchange period (a maximum 180 calendar days). In addition, the taxpayer must not have a direct or indirect right to receive or otherwise obtain the benefit of the exchange proceeds during the exchange period except to acquire like-kind replacement property. Any non like-kind property received by the taxpayer in the exchange usually referred to as boot, will cause the taxpayer to recognize gain. Under the foregoing rules, the use of exchange funds to pay expenses not related to the exchange could invalidate the exchange to the extent that such use results in the taxpayer's constructive receipt of exchange proceeds. In other cases, payment of an expense related to the disposition of relinquished property or acquisition of replacement property may give rise to taxable boot in the exchange, but would not create a constructive receipt problem. Finally, payment of certain costs related to the transfer of the relinquished property which may be characterized as selling expenses or exchange expenses are excluded from the seller's amount realized and ignored altogether.

Treasury Regulation §1.1031(k)-1(g)(7) permits certain transactional expenses related to the 1031 exchange transaction to be paid from exchange proceeds without disqualifying the exchange. These include items which relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees). *See also* Letter Ruling 8328011.

Similarly, proposed regulation §1.468B-6(b) states that transactional expenses are "***the usual and customary expenses paid or incurred in connection with a deferred exchange*. *For example, the costs of land surveys, appraisals, title examinations, termite inspections, transfer taxes, and recording fees are transactional expenses.***" While the payment of transactional expenses from proceeds will not disqualify an exchange, payment of such items out of exchange proceeds may generate boot resulting in the recognition of some taxable gain. Thus, a careful review of the closing statements on the relinquished property sale and the replacement property purchase before closing is strongly recommended. Often an item which would generate boot can be dealt with in a way that will avoid characterization as such.

IRS Form 8824, the tax form filed with the IRS to report a 1031 exchange transaction, provides that exchange expenses are to be deducted from the contract price in the determination of realized gain. In this context, the term exchange expense is not defined but appears to mean an expense of sale that would be excluded from the amount realized in a taxable sale transaction. Examples of these expenses include qualified intermediary (QI) fees, escrow closing costs, and broker commissions. *See e.g.* Letter Ruling 8328011, *Mercantile Trust Co. of Baltimore v. Comm*, 32 BTA 82 (1935), Rev. Rul. 72-456, 1972-2 CB 468.

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Other selling expenses which may be excluded include transfer taxes, attorney's fees, recording fees and the cost of the owner's title insurance policy. Note, however, that an excludable selling expense does not encompass all closing costs or transactional expenses which may be paid with exchange proceeds within the safe harbor provisions of the regulations. For instance, real estate taxes, rent, and other proration and adjustments are not excluded from the amount realized in a taxable sale or added to the basis of the property by the buyer. Rather, they are operating costs incurred due to the ownership of the real property. Likewise, as to possible costs to remove or satisfy mechanic's liens or other assessments.

Unfortunately, the use of exchange proceeds to pay certain costs related to the exchange could result in receipt of boot or even in a failed exchange. The line between transactional items which can safely be paid and those which would cause the taxpayer to be in constructive receipt of exchange funds are not well settled in all cases. For example, loan-related fees, such as prepaid interest, mortgage insurance fees, appraisal fees, and lender's title insurance relate to the loan used to acquire replacement property and may not fall within the scope of Treasury Regulation §1.1031(k)-1(g)(7). Loan costs are generally capitalized and recovered over the term of the loan and are not included in the cost basis for the replacement property. *See Rev. Rul.* 70-360, 1970-2 CB 103, *S&L Building Corporation,* 19 BTA 788 (1930). Accordingly, tax authorities could take the position that the qualified intermediary's use of exchange proceeds to pay such costs results in boot or even in a failed exchange. Given the uncertainty, the use of exchange funds to pay loan related costs should probably be avoided. Again, there is no substitute for qualified tax advice regarding each taxpayer's unique facts and circumstances.

Security deposits, repair costs and prepaid rent which are allocated among buyer and seller in a purchase and sale contract through a standard prorations clause can be another source of taxable boot if not handled carefully. The prorations clause works by adjusting the amount of cash that must be paid by the buyer at closing. For example, a typical rent proration clause would credit the buyer with rents already received by the seller which are allocable to the period following the closing thereby reducing the amount of cash the buyer must deposit. Such a clause generates boot because the seller has, in effect, treated the prorated amount allocated to the buyer as part of the buyer's consideration for the property. At closing, this cash is in the seller's hands and does not pass to the seller's qualified intermediary to be used in the exchange. This is boot, plain and simple. This result could be avoided by having the seller deposit the prorated rents into escrow before the closing. The same rationale applies to other prorated items credited to buyer at closing in the purchase and sale agreement, such as a buyer credit for repairs. In the latter case, a seller may prefer to reduce the purchase price for the property to reflect the cost of the repair (but such a reduction might interfere with the buyer's financing). The characterization of closing costs, exchange expenses, and prorations in a tax-deferred exchange is an area that can be complex and is generally not well understood by real estate investors. A pre-closing analysis of these items by a qualified tax professional will often turn up potential boot items that can be avoided with proper planning.

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