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Internal Revenue Code Â§1031 exchange: Closing costs and "allowable" exchange expenses

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A frequently asked question is: "What items can be deducted from the exchange proceeds of an exchange transaction without resulting in a tax consequence?" Although, the IRS has not published a complete list of qualifying expenses, there are some rulings that provide general parameters.

Treasury Regulation Â§1.1031(k)-1(g)(7) permits certain transactional expenses related to the exchange transaction to be paid from exchange proceeds without disqualifying the exchange. These include items that 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. See also Letter Ruling 8328011. Proposed regulation Â§1.468B-6(b) states that transactional expenses are "the usual and customary expenses paid or incurred in connection with a deferred exchange. The costs of land surveys, appraisals, title examinations, termite inspections, transfer taxes, and recording fees are transactional expenses." While the payment of transactional expenses out of 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. 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 that would generate boot can be dealt with in a way that will avoid characterization as boot.

IRS Form 8824, the tax form filed with IRS to report a Â§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 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. Other selling expenses that might 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 that may be paid with exchange proceeds within the safe harbor provisions of the regulations. Real estate taxes, rent and other prorations and adjustments are not excluded from 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.

Transactional items that may be paid from exchange proceeds in an exchange, but are usually not considered selling expenses include loan related fees, such as points, mortgage insurance fees, appraisal fees, lender's title insurance premiums and other fees related to financing the acquisition of the replacement property. Such fees must be amortized over the life of the loan, do not increase basis in the property and do not affect the calculation of realized or recognized gain. Rev. Rul. 70-360, 1970-2 CB 103, S&L Building Corp., 19 BTA 788 (1930). While the payment of such costs from proceeds may result in cash boot in the exchange, such expenses may be deductible as well. Some legal and tax advisors take the position that where financing is an express condition to closing in the purchase contract, the payment of finance related fees out of exchange proceeds should not generate boot.

Security deposits, repair costs and prepaid rent that are allocated among buyer and seller in a purchase and prorations clause works by adjusting the amount of cash that must be paid by the buyer at closing. A typical rent proration clause would credit the buyer with rents already received by the seller that are allocable to the period following the closing thereby reducing the amount of cash the buyer must deposit. Such a clause generates boot as 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 seller's QI to be used in the exchange. This is boot, plain and simple. That 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 by a qualified tax professional will often turn up potential boot items that can be avoided with property planning. The goal for some of course, is to obtain complete tax deferral.

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