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What to do about closing costs in a 1031 exchange? - by Pamela Michaels

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A question that arises in many 1031 exchanges is what costs can be paid from sale proceeds without resulting in taxable boot or potentially disqualifying the exchange? In New York and the Northeast generally, costs related to real estate transactions can be significant so it is critical to understand the tax impact of paying such costs from sale proceeds.

To obtain complete deferral of capital gain taxes in an exchange otherwise meeting the requirements of Section 1031, a taxpayer should reinvest all net sale proceeds from the sale of relinquished property in like-kind replacement property within the applicable exchange period (a maximum 180 calendar days). Any non like-kind property received by the taxpayer, referred to as “boot,” results in gain recognition on the boot received. Under the foregoing rules, the use of exchange funds to pay expenses not related to the exchange could potentially invalidate the exchange to the extent such use results in the taxpayer’s constructive receipt of exchange proceeds. In other cases, payment of expenses related to the disposition of relinquished property or acquisition of replacement property may give rise to taxable boot. Finally, payment of certain costs related to the transfer of the relinquished property that 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 a 1031 exchange transaction to be paid from exchange proceeds without disqualifying the exchange. These are expense 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 (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 out of proceeds will not disqualify an exchange, payment of such items 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 that would generate boot can be dealt with in a way that will avoid characterization as boot.

IRS Form 8824, Like-Kind Exchanges, the tax form filed with IRS reporting 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 amount realized in a taxable sale transaction. Examples of these expenses include qualified intermediary 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. For instance, 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 associated with 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 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 generally 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 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, typically security deposits are credited against the purchase price in a real estate sale. However, doing so in a §1031 exchange will generate boot as the seller has, in effect, treated the security deposits 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 qualified intermediary to be used in the exchange. This is boot, plain and simple. That result could be avoided by having the seller bring such security deposits to closing or by the seller paying the deposits to the buyer outside of 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. The goal for some taxpayers, of course, is to obtain complete tax deferral.

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