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IRC § 1031 Exchange Expenses: What are they and how do they affect the exchange?

When engaging in an IRC §1031 Tax Deferred Exchange, it is important to note that the use of your exchange proceeds to pay some of your closing costs for the relinquished and replacement properties may result in "boot". Boot is any property received in an exchange that is not like kind to the property disposed of in the exchange. In a real property transaction, property received that is not like kind may include such items as cash, a mortgage note, a boat, or stock. The Exchanger pays taxes on the boot to the extent of realized capital gain.

The authority addressing the treatment of exchange expenses is limited. Revenue Ruling 72-456 however, does provide that brokerage commissions reduce the realized gain and recognized gain of the taxpayer and increases the tax basis of the replacement property. No specific authority exists for the deduction of any transactional cost from realized gain other than commissions. PLR 8328011, however, implies that other transactional expenses should be disregarded if paid from the exchange proceeds in connection with the exchange. These costs are referred to as "exchange expenses" on IRS Tax Form 8824, but are not specifically listed anywhere. The question then becomes "what is an exchange expense"? The following is a list of items that most tax practitioners consider allowable exchange expenses for purposes of reducing realized gain and recognized gain:

- Exchange or Accommodator fees
- Messenger fees
- Escrow, Processing and
- Statement fees
- Finder fees
- Tax service fees
- Inspection and testing fees
- Notary and Recording fees
- Brokerage commissions
- Title insurance premiums
- Documentary Transfer taxes
- Legal/Consulting fees incurred in the transaction

Likewise, the following is a list of closing costs that are not considered exchange expenses and may be treated as boot:

- Rents
- Security Deposits
- Utilities
- Property taxes
- Property insurance
- Association dues
- Repairs and Termite work
- Credits to Buyers for non-recurring closing costs or repairs
- Loan Acquisition fees (such as points, mortgage insurance, application fees, lender's title insurance, assumption fees, appraisal fees, hazardous waste/property inspections required by the lender)

While these items may result in taxable boot, they may also be deductible as interest, taxes or operating expenses (subject to the passive loss limitation of IRC § 469). See IRC §§ 162, 163, 164, 1001(b). Security deposits are cash boot if held in a separate account by the landlord and are mortgage boot if not required to be segregated.

Accordingly, where a security deposit can be classified as mortgage boot, it may not be necessary to bring the security deposits into the closing of the relinquished property if the Exchanger intends to acquire equal or more debt or bring additional cash in for the purchase of the replacement property. The chart above is an example. In this example, the security deposits are an obligation of the Exchanger and credited to the buyer, resulting in debt relief to the Exchanger. Here, the debt was reassumed in the purchase of the replacement property with additional cash in or mortgage assumed.

In any transaction where the exchanger pays closing costs that are necessary for the disposition of the relinquished property or the

RELINQUISHED PROPERTY		REPLACEMENT PROPERTY	
Selling Price	\$600,000	Purchase Price	\$545,000
Mortgage	\$300,000	New Mortgage	\$300,000
Security Deposits (credited to Buyer)	\$25,000	Down Payment	\$230,000
Closing Costs	\$45,000	Closing Costs	(\$10,000)
Net Equity	\$230,000	Additional Cash or Mortgage	\$25,000

acquisition of the replacement property, the payment of such costs effectively reduces the amount the exchanger has to spend for the replacement property. In other words, if a commission paid on the relinquished property reduces the cash to the exchanger by \$30,000, then the exchanger can spend \$30,000 less than the selling price of the relinquished property.

Likewise, where an exchanger pays for items that may not be allowable exchange expenses – e.g., insurance and real property taxes – the payment of those expenses will lower the amount the exchanger needs to spend for replacement property and will be taxable as boot.

In general, expenses may be paid through escrow but may be boot depending on whether they're allowable or non-allowable exchange expenses. Only items that are *transactional items*, however, may be paid by the Qualified Intermediary during the exchange period without affecting the Qualified Intermediary safe harbor under Reg. Sec. 1.1031(k)-1(g). Transactional items are defined under Reg. Sec. 1.1031(k)-1(g)(7)(ii) as items that relate to the disposition of the relinquished property or the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of the buyer or seller. It should be noted that loan acquisition fees such as loan fees, points, appraisal fees, assumption fees, lender's title insurance, and other costs related to the loan are costs associated with obtaining the loan and should not be paid for with exchange proceeds.

