# Closing Costs and the Tax Deferred Exchange

There is little authority in the Internal Revenue Code or Treasury Regulations as to how to treat the variety of expenses and closing costs which may be associated with the sale or purchase of an exchanged asset. Given the general rule that an Exchanger must transfer all equity in the Relinquished Property to the Replacement Property, the issue is whether payment of typical sale and purchase settlement expenses out of the Relinquished Property sale proceeds (exchange funds) will result in taxable "boot" to the Exchanger.

There is an open issue as to whether the Qualified Intermediary's use of exchange funds to pay for costs and expenses to close on the Replacement Property affect the safe harbor restrictions of Treas. Reg. §1.1031(k)-1(g)(6). Treasury Regulations provide that payment of transactional items related to sale or purchase of the exchanged properties that typically appear on closing statements as the responsibility of a buyer or seller, such as broker's commissions, prorated property taxes, recording fees, transfer taxes and title company fees, may be paid from exchange funds and will not be construed as constructive receipt of funds by the Exchanger. Treas. Reg. §1.1031(k)-1(g)(7). Following this rationale, other typical closing costs customarily appearing on settlement statements that may generally be paid without concern of breaching the safe harbor include qualified intermediary fees, direct legal fees, costs of surveys, and environmental inspections related to the exchanged properties.

Prorations and closing costs may still affect the calculation of basis or gain, or may constitute boot to the Exchanger if they either are not offset, or are deemed to be not directly related to the sale or acquisition. Revenue Ruling 72-456 provides some guidance regarding the impact of transactional costs. It specifies that real estate brokers' commissions paid are offset against cash received in computing gain, and are added to the basis of the Replacement Property. For example, Broker's commissions paid on Relinquished Property reduce gain and offset boot. If they are paid on Replacement Property (not very common) they increase the basis of the Replacement Property (as do Qualified Intermediary fees).

Certain costs may create taxable boot because they are seen as expenditures for benefits other than acquiring the Replacement Property. Loan fees, points, prorated mortgage insurance, loan appraisal fees and any other lender mandated inspections not otherwise required under the purchase and sale contract are generally considered to be costs of obtaining a new loan, rather than direct costs of acquisition of the Replacement Property. An easy test is to ask if the expense would exist if the transaction was cash only.

Prorated property taxes, insurance payments, rents and security deposits are usually considered to be outside of the exchange, but because they customarily appear on closing statements, the payment of these typical items should not interfere with the safe harbor. The Exchanger may wish to consider prorated property tax payments or security deposits credited to the buyer of the Relinquished Property as the equivalent of non-recourse debt from which the Exchanger was relieved. While this treatment initially creates mortgage boot received, this payment can be netted against liabilities assumed (mortgage boot paid) on the purchase of the Replacement Property. See TAM 8328011 regarding prorated rent payments.

Use of exchange proceeds for expenses unrelated to the direct purchase or sale of the exchanged properties can create significant issues. In addition to potentially creating taxable boot, it can be deemed to be receipt of exchange funds (or a benefit therefrom) in violation of Treas. Reg. §1.1031 (k)-1(g)(6), causing the exchange to fail. Exchange funds should not be used to pay off debt unrelated to the Relinquished Property, such as a line of credit, credit card debt, or other debt that is not secured by the Relinquished Property.

Because of these issues and the lack of clear guidance in the law, an Exchanger should always discuss treatment of closing costs with their tax advisor prior to the respective closing.