

EXCHANGES AND CLOSING COSTS

A common question surrounding 1031 exchanges is “What transaction expenses can be deducted from my exchange proceeds without causing a taxable event”? Unfortunately, the Internal Revenue Service has never published a list of specific qualifying expenses. We find, however, that there is some guidance that closing costs can be paid for using exchange funds.

One official ruling, Revenue Ruling 72-456, has been issued on the subject of 1031 exchanges and transaction expenses. In this ruling, guidance was provided to indicate that brokerage commissions can be deducted from the exchange proceeds. In the Private Letter Ruling 8328011, a taxpayer was allowed to deduct other types of transaction costs if they were paid in connection with the 1031 exchange. Lastly, the IRS Form 8824 (the form that accompanies a federal tax return to report the exchange) provides for the deduction of transaction costs, which are referred to as “exchange expenses”.

EXCHANGE EXPENSES

“Exchange expenses” include the transaction costs that are incurred solely as a result of the relinquishment and acquisition of property through the 1031 exchange. Most tax advisors agree that the following transaction costs are exchange expenses and may be paid at the closing of the relinquished or replacement properties without any tax consequence:

- Real estate/brokerage commissions
- Closing/escrow fees
- Title insurance premiums
- Transfer taxes
- Legal fees
- Notary fees
- Recording fees
- Qualified Intermediary fees

NOT EXCHANGE EXPENSES

Most tax advisors believe that fees in connection with getting a loan to acquire replacement property are costs of the loan, not costs of acquiring the replacement property (exchange expenses). As a result, if the exchangor uses exchange funds to pay for loan costs, it is likely that doing so will create a tax liability. To avoid this tax liability, the exchangor may choose to pay for any loan related costs out of their pocket, and not from the exchange account.



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Financing costs that should not be deducted from the proceeds may include:

- Lender's title insurance
- Mortgage insurance
- Mortgage points or interest
- Credit report fees
- Loan origination or application fees
- Assumption fees
- Appraisal fees
- Environmental investigation costs that are required by the lender

Additional Non-Exchange Expenses:

Property taxes are non-exchange expenses that create a tax liability, but are offset by a deduction. In addition, security deposits and prorated rents are not considered exchange expenses and if exchange funds are used to pay them, the exchange will be partially taxable. In other words, any sale proceeds used to transfer rents and security deposits to a buyer would be considered boot. To avoid this taxable event, these items should be handled outside of escrow, or these non-transaction costs should be paid for by making a separate deposit into the escrow.

The following transactional costs are typically found on a closing statement, are not exchange expenses and thus, are not added to the basis of the replacement property:

- Pro rata property taxes
- Tenant security deposits
- Pro rata or prepaid rents
- Utility escrow deposits or charges
- Homeowner's association fees
- Hazard insurance premiums

These lists are not meant to be inclusive. **A taxpayer should review their individual transaction costs with their tax and/or legal advisors to determine whether costs related to the closing considered are exchange expenses or not.**