

Closing Costs and the Tax Deferred Exchange

Exchangers, closing agents, escrow officers and tax advisors have struggled with the many issues presented by the variety of expenses and cash payments associated with closing the properties in an exchange transaction. To make matters less certain, there is little authority in the Internal Revenue Code or Treasury Regulations as to how to treat the closing cost items commonly seen on settlement statements. The following are answers based on existing authority to typical issues seen on settlement statements. Given the general rule that an Exchanger must transfer all equity in the relinquished property to the replacement property, the issue is whether the Exchanger will be taxed on the amount of the sale proceeds used to pay typical sale and purchase settlement expenses.

Revenue Ruling 72-456 that specifies that real estate sale commissions paid are offset against the sale proceeds received provides some guidance. The purchase commissions paid are added to the basis of the replacement property. Therefore, payment of brokerage commissions from exchange proceeds does not create taxable boot.

Based on this rationale, the same favorable treatment may be accorded other sale and purchase expenses. Payment of the following non-recurring costs of sale or purchase from the exchange proceeds should not create taxable boot:

Real estate commissions
Intermediary fees
Title insurance premiums
Documentary transfer taxes
Escrow or closing agent fees
Direct legal fees
Recording fees
Agreed property inspections

However, certain costs may create taxable boot because they are seen as expenditures for benefits other than acquiring the replacement property. Loan fees, points and prorated mortgage insurance are really costs to obtain a new loan. Prorated property taxes, insurance payments and rents are usually considered deductible ongoing operating expenses and not part of the exchange. Payment of appraisal fees, inspections, surveys and environmental studies are also typically considered taxable boot if they are used to obtain a new loan for the replacement property. **If, however, the Purchase and Sale Agreement for the replacement property was specifically made contingent upon the satisfactory completion of these items, the Exchanger could argue that these expenditures were really for the purchase of the property and not to obtain a new loan.**

The Exchanger may wish to consider prorated property tax payments or security deposits paid 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.

There is an issue as to whether the Intermediary's use of exchange funds to pay for the costs and expenses to close on the replacement property affect the safe harbor restrictions of Treas. Reg. 1.1031(k)-1(g)(6). The Treasury Regulations are clear that normal costs of sale or purchase, including commissions, fees and property taxes may be paid from the exchange proceeds and will not be construed as constructive receipt of funds by the Exchanger. However, using exchange proceeds for closing expenses unrelated to the direct purchase of the replacement property must only be made at the time of closing the replacement property when the Qualified Intermediary pays out all of the exchange funds it is holding in accordance with the restrictions for completing the exchange set forth in Treas. Reg. 1.1031(k)-1(g)(6).