First American Title
NATIONAL COMMERCIAL SERVICES

AVOIDING BOOT AT THE CLOSING OF A 1031 EXCHANGE

Posted by [Mary Kay Kennedy] on Thu, August 11, 2016 @ 02:00 PM

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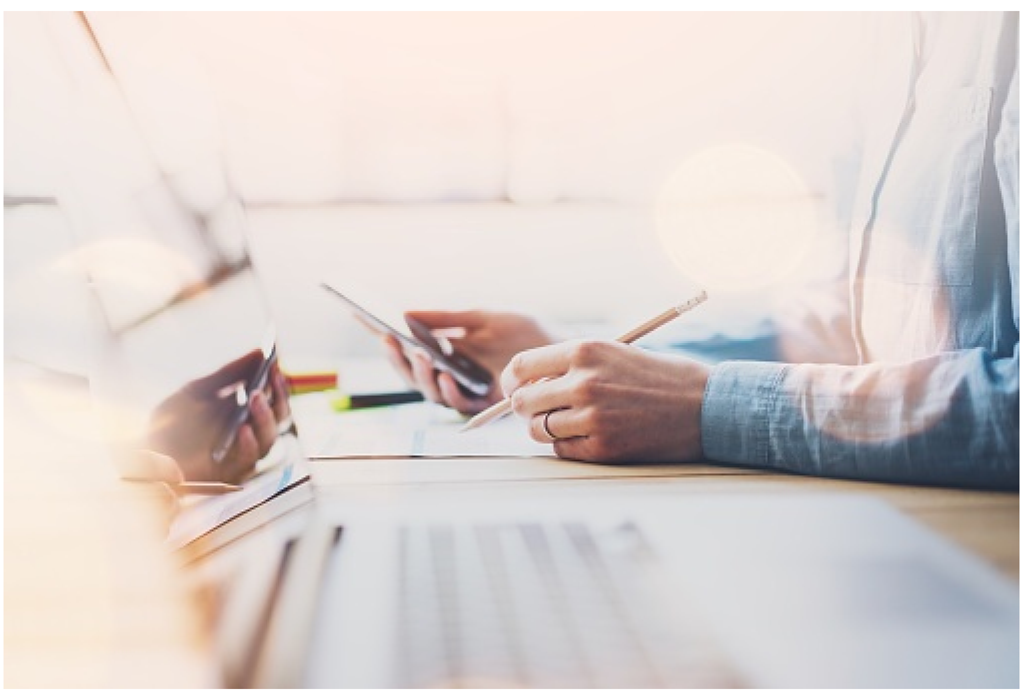

Exchange vs. Non-Exchange Expenses

When closing a 1031 exchange transaction, it's important to focus on which expenses are being paid with exchange funds. Some expenses that are expenses of owning property (such as property taxes and insurance) rather than expenses related to the sale or purchase are considered "non-exchange expenses." If exchange funds are used to pay non-exchange expenses, the transaction may be partially taxable.

Expenses that are related to the sale or purchase are considered "exchange expenses" and using exchange funds to pay those expenses won't result in taxable boot. For example, broker's commissions are considered exchange expenses. If the taxpayer uses the exchange proceeds to pay the broker's commission, it will not affect the exchange. In addition to broker's commissions, most tax advisors consider the following to be exchange expenses: title insurance fees for the owner's policy, exchange fees, escrow fees, transfer taxes, recording fees and attorneys' fees.

At the sale of the relinquished property, it's common for the seller to give the buyer a credit for security deposits and prorated rents. Doing this is equivalent to using the exchange funds to pay for non-exchange expenses and will result in the transaction being partially taxable.

For example, if the seller is selling the property for $10 million, and the seller owes the buyer $500,000 for security deposits and prorated rents, the closing statement will typically offset one against the other and the seller will get $9.5 million instead of $10 million. The closer will send the qualified intermediary $9.5 million and the additional $500,000 used to pay the security deposits and prorated rents will be considered boot.

A solution to this is for the seller to come in with its own cash to pay the security deposits and prorated rents to the buyer. Although this is not necessary for a valid exchange, it will ensure that the $500,000 does not result in taxable boot to the seller.

In addition, most tax advisors believe that fees and costs incurred in connection with getting the loan to acquire the replacement property are costs of the loan, not costs of purchasing the replacement property, and therefore are not exchange expenses. If the investor uses exchange funds at the closing of the replacement property to pay loan costs and fees, it is likely to create taxable boot. To avoid this, the buyer may want to deposit its own funds to pay any loan-related expenses.

Transactional Items and Constructive Receipt

A separate, but important, issue is whether paying an expense will show that the investor has constructive receipt of the exchange funds, which has the potential to ruin the entire exchange. Under these rules, exchange funds can be used to purchase the replacement property, including making deposits, and to pay "transactional 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 statement as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees)."

Because of the wording of the regulations, costs that are <u>not</u> typically paid on a closing statement in the area where the property is located (even if they are related to the acquisition of the property) may trigger a constructive receipt problem if exchange funds are used to pay them.

References

Revenue Ruling 72-456; Treasury Regulation Section 1.1031(k)-1(g)(6) and (7); IRS Form 8824.