



# First American Exchange

A QUALIFIED 1031 EXCHANGE INTERMEDIARY

## *Closing Costs in a 1031 Exchange*

### *Introduction*

There are two important issues to consider when determining how to handle expenses in a 1031 exchange.

The first has to do with whether handling the expense in a certain way will result in the exchange being partially taxable. There are certain categories of expenses called “exchange expenses” that can be paid with exchange funds and doing so won’t result in the transaction being partially taxable.

The second issue has to do with whether paying the expense will be evidence that the taxpayer has constructive receipt of the exchange funds. If this happens, it is as if the taxpayer is controlling or actually holding the exchange funds, and the exchange may be completely ruined because it will be considered a sale followed by a purchase rather than an exchange under federal tax law.

As with many 1031 exchange issues, there is very little guidance on this topic. This article explains generally what the issues are; however, because of the uncertainties and the technical nature of these issues, it is essential that every taxpayer have his tax advisor approve each closing statement and the manner of paying all costs, so that there are no surprises when filing his tax return.

### *Exchange Expenses*

Certain expenses paid at a closing are considered “exchange expenses” and using exchange funds to pay those expenses won’t result in any tax liability to an investor doing a 1031 exchange. For example, Revenue Ruling 72-456 provides that if exchange funds are used to pay broker’s commissions, it does

not result in the transaction being partially taxable. There are no other clear rulings on this subject, but most tax advisors agree that the following expenses are exchange expenses and may be paid at the closing of the relinquished or replacement properties without any tax consequence:

- Broker’s commissions
- Exchange fees
- Title insurance fees for the owner’s policy of title insurance
- Escrow fees
- Appraisal fees required by the purchase contract
- Transfer taxes
- Recording fees
- Attorney’s fees incurred in connection with the sale or purchase of the property

### *Non-Exchange Expenses*

Other expenses are not exchange expenses, so although exchange funds can be used to pay the expense, doing so results in the exchange being partially taxable. For example, 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. This comes up when the seller of the relinquished property gives the buyer a credit at the closing for the security deposits and prorated rents. The result of the credit is as if the seller was using exchange funds to pay the security deposit and prorated rent amounts to the buyer. To avoid the tax, the seller should deposit his own funds to pay those security deposits and prorated rents to the buyer.

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In addition, most tax advisors believe that fees and costs 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 under tax law 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 doing so will create a tax liability. To avoid the tax liability, the buyer may want to deposit his own funds to pay any loan related expenses.

Some non-exchange expenses create a tax liability but are offset by a deduction. One example of this is property taxes. Although property taxes are not an exchange expense, the investor will get a deduction for paying the property taxes and so the liability will be offset by the deduction.

The following is a list of expenses that are typically found on a closing statement but are generally not considered exchange expenses:

- Loan costs and fees
- Title insurance fees for lender's title insurance policy
- Appraisal and environmental investigation costs that are required by the lender
- Security deposits
- Prorated rents
- Insurance premiums
- Property taxes

## *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 for typical costs related to the sale or purchase, such as prorated rents and broker commissions. The

actual wording of the regulation is that exchange funds can be used 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 not typically paid on a closing statement in the area where the property is located, and costs that are unrelated to the sale or purchase, may trigger a constructive receipt problem if exchange funds are used to pay them. In addition, as a result of the wording of this rule, many tax advisors caution against paying expenses with exchange funds in between the closing of the relinquished and replacement properties.

One common situation where this issue arises is when an investor wants to use exchange funds to pay rate lock-in fees to a lender. Since these fees by their nature are paid before the closing to lock in an interest rate, they do not “appear under local standards in the typical closing statement,” and therefore may trigger a constructive receipt problem. Since there is no clear IRS interpretation of this rule, investors need to discuss the issue with their tax advisors before paying unrelated expenses at a closing or any expenses in between closings.

## *References*

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

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