

EXPENSES PAID IN CONNECTION WITH YOUR TAX DEFERRED EXCHANGE

It is widely held that certain closing costs may be paid from exchange funds, and do not raise concerns about constructive receipt of exchange funds or receipt of taxable boot. The only item which is specifically mentioned in any IRS literature is real estate brokerage commissions, however Letter Ruling 8328011 lends to the commonly held belief that transactional expenses should be "disregarded" if paid from the exchange proceeds. IRS form 8824 refers to these items as "exchange expenses", but the IRS does not provide a list of such permitted expenses. Revenue Ruling 72-456 and General Council Memorandum 34895 lend further authority for this proposition.

Generally, permitted expenses will reduce the amount realized from the relinquished property and increase basis in the replacement property. Even if an expense is listed as such on the closing statement, it does follow that it is a permitted expense for purposes of section 1031. The expenses that are believed to be permitted to pay out of exchange funds without being deemed boot are as follows:

Attorneys Fees	Loan Fees paid by Seller for the Buyer	Real Estate Sales Commission
City/County/State tax (transfer) stamps and fees	Home Warranty Fee (not for Exchangor)	Settlement or Closing Fee
Delivery Charges (e.g. messenger, FedEx, UPS)	Notary Fee	Survey (split on authority on this one)
Document Preparation Fees (non loan)	Pest Inspection *	Termite Report
Environmental Reports*	Phase I & Review *	Title Insurance Fees
Repair Expenses required by Purchaser	Qualified Intermediary Fees	Transfer Taxes
Homeowners Association Transfer Charge	Recording or Transfer fees	Wire Fee (not related to loan)

It is important to note that these fees should be related to obtaining the replacement property and not to any loan taken out. Any fees in connection with a loan Again, the above are based upon the consensus of the 1031 community and tax professionals, but are not warranted.

It is generally accepted that closing costs such as loan fees, points, taxes, prorated rents, mortgage insurance, appraisal fees, inspections, surveys, environmental studies, security deposits, and certain escrows cannot be paid with exchange funds without creating tax liability. These costs are seen as expenditures for items other than acquiring or disposing of the property, however there may also be offsets from tax liability due to payments

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being deemed equity contributed toward the replacement property.

Related to the analysis of the whether payment of exchange expenses out of proceeds is treated as an allowed expense or boot, is the effect of unallowed expenses on the exchange safe harbors. The IRS regulations do provide that “the use of money or other property held by a qualified intermediary to pay certain specified items will not result in actual or constructive receipt of the remaining funds and, furthermore, will be disregarded in determining whether the transaction would otherwise qualify under the applicable safe harbor provisions of the regulations.” Items that will not jeopardize the safe harbors include “items a seller may receive as a consequence of the disposition of property, and that are not included in the amount realized from the disposition of property”; and “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.” The Regulations explicitly mention prorated rents, commissions, prorated taxes, recording or transfer taxes, and title company fees, however the language in the regulations make it unlikely that these are the only items to be disregarded for safe harbor purposes.

A complete analysis of tax implications of exchange expenses would go beyond the basic nature of this document, and would probably run the length of this booklet. Exchangors should always review their estimated settlement statement and/or HUD-1 statement with their tax and/or legal advisors prior to approving the estimated expenses and closing costs to ensure they have an accurate and complete understanding of the income tax consequences from the transaction prior to closing. Advisors may recommend that Exchangors pay for certain costs at the close of the transaction with personal funds in order to avoid creating taxable boot or constructive receipt of exchange funds.

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