What can be paid out of the Exchange Account?

We get this question a lot and the answer isn’t an easy one. There is very little authority on the subject. Treas Reg §1.1031(k)-1(g)(7) permits the payment of certain transactional items that relate to the disposition of the relinquished property and replacement property. Our interpretation is that the following closing costs come off the top of the sale price and won’t create taxable “boot.”

- Commissions
- Exchange company fees
- Escrow/settlement fees
- Recording fees
- Owner’s title insurance fee
- Legal fees associated with negotiating the sale/purchase

The following fees may be paid at the time of closing but will create taxable boot. They are not closing costs but do “appear under local standards in the typical closing statements…”

- Loan related expenses – loan application fee, appraisal, etc.
- Security deposits
- Proration of rents
- Property taxes
- Insurance
- HOA fees
- Legal fees for services other than negotiating the sale/purchase – 1031 advice, estate planning, etc.
- Repairs to the relinquished property

Important point: The exchange will not fail due to payment of these items and, in fact, there may be business deductions, etc. to mitigate the tax implications. Further, if the Exchanger wishes, they can bring a check to closing to pay for these items.

The question arises as to whether loan related expenses (application fee, appraisal fee, etc.) can be paid prior to closing on the replacement property. These can be substantial. Exchangers frequently don’t want to come out of pocket for these fees. While it is permissible to pay them at closing it is an open question whether payment prior to closing could be construed as a violation of the safe harbor restrictions of Treas Reg §1.1031(k)-1(g)(6). It is recommended that the Exchanger pay these out of pocket.