CHICAGO DEFERRED EXCHANGE
CORPORATION

SELLING EXPENSES IN A MULTI-PARTY EXCHANGE

The only IRS authority on the treatment of selling expenses is found in the Revenue Ruling 72-456, 1972-2 C.B. 468 and its supporting General Counsel's Memorandum 24895 (June 5, 1972). The ruling and the GCM indicate that cash received by a Taxpayer in an exchange is offset by commissions paid in computing amount realized and gain recognized, and that brokerage commissions are added in determining the basis of replacement property.

Although this guidance deals only with brokerage commissions, its principles should apply to all expenses incurred in either the disposition of the relinquished property or the acquisition of replacement property. These types of expenses are generally those listed in IRC Section 1001, and include inspection and testing fees, title insurance premiums, escrow fees, transfer taxes, recording fees, and legal fees related to the exchange.

Prorated rents, real estate taxes, utilities, and property insurance premiums are not selling expenses and should be taxable as ordinary income to the Taxpayer outside the exchange.

Loan application fees, points, mortgage insurance, lenders title insurance and assumption fees are costs related to the acquisition of financing for the replacement property, not the replacement property itself, and therefore do not increase the basis of the replacement property. If these loan related expenses are paid out of the exchange balance, they should constitute taxable boot. These expenses can be netted against cash paid by the Taxpayer, and should be amortized over the term of the loan.

Exchange fees are directly related to the exchange and therefore should be treated the same as other selling expenses.

When can Selling Expenses be Paid from the Qualified Exchange Trust Account?

Selling expenses can be paid at any time during the exchange period without affecting the safe harbors if they are transactional items under Reg. §1.1031(k)-1(g)(7). All of the expenses described above, **with the exception of loan application fees**, should be treated as transactional items even though some do not appear on the closing statement.

Expenses and Fees Incurred in a Multi-Party Deferred Exchange

In a typical multi-party deferred exchange, the expenses and fees incurred by the Taxpayer may include the following: attorneys' fees in connection with structuring the exchange; attorneys' fees in connection with the transfer of the properties and the closings; accountants' fees; brokers' fees for the property transferred and/or acquired; mortgage fees; appraisal fees; Qualified Intermediary fees; trustee fees. To what extent can these fees be used to offset boot received in the exchange?

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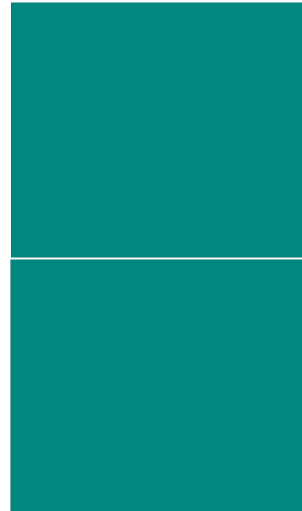
Parties to a Section 1031 exchange who receive boot will recognize gain to the extent of the lesser of the realized gain or the boot received under IRC Section 1031(b). Realized gain is the excess of the amount realized over the adjusted basis of the property transferred. The amount realized in an exchange equals the sum of the fair market value of property received, cash received, and liabilities assumed by the other party. Non-deductible expenses typically are subtracted, along with adjusted basis from the amount realized in capital transactions to determine realized gain.



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The Regulations indicate that boot may take the form of non-qualifying real or personal property, cash, or relief from a liability. In an exchange in which each party either assumes a liability or transfers property subject to a liability, boot is determined by offsetting the liabilities. The party who is relieved of a greater liability than that which he assumes pursuant to the exchange is deemed to receive boot equal to the difference between the two amounts. Example #2 of Regulation Section 1.1031(d)-2 provides some further guidance with respect to netting cash paid or received in an exchange and concludes that the Taxpayer (D) is not permitted to offset the excess liability he assumes on a replacement property against cash received. This example is the only authority which the IRS cites in Revenue Ruling 72-456 in support of its conclusion that money paid for brokerage commissions may offset money received by a party to a Section 1031 exchange for purposes of computing both realized and recognized gain.

The list of costs which could conceivably fall within the scope of Revenue Ruling 72-456 is potentially very lengthy. Expenses of consummating an exchange under Section 1031 may include brokerage commissions, fees to escrow agents, title search and other legal fees, commissions, advertising expenses, appraisal fees, transfer taxes, recording fees, title insurance, surveyors' fees, costs of preparing property for sale, and many others. The IRS has indicated that the scope of the Ruling is not limited to brokerage commissions. The Ruling itself interprets example #2 in the Regulations as standing for the apparently general principle that "money paid out in connection with an exchange under Section 1031" may be offset against cash received. The General Counsel's Memorandum issued in connection with Revenue Ruling 72-456 determined that there was no significant difference between cash paid to the other party to the exchange in example #2 of the Regulations and cash paid to the broker in the Ruling because in both cases money was paid "to consummate the exchange." The Memorandum concluded that the difference in identity of the payee "is not meaningful." Finally, the IRS ruled in Private Letter Ruling 8145100 that, consistent with example #2 and Revenue Ruling 72-456, the Taxpayer could reduce his boot or realized gain on a Section 1031 exchange of real estate by his "selling expenses" but did not identify the specific expenses incurred. Further clarification from the Service is needed in order for Taxpayers to understand where the line will be drawn. *See also* ***Blatt v. Commissioner*** *infra at page 65 where the Court stated that "the amount of boot received is decreased by the Taxpayer's exchange expenses."*

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