Avoiding Boot in a §1031 Exchange: Trigger Items on a Closing Statement

A Smarter About Taxes Guide

To avoid unforeseen boot in closing a 1031 transaction, please follow these instructions. This document references the seller side (relinquished property). Please see the buyer-side document for closing a replacement property.

There are 3 sections to this guide: items you MUST cover with funds brough to closing (or outside closing); items you SHOULD cover; and items that are OK to come from 1031 funds.

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MUST ITEMS

These items will unequivocally trigger taxable boot if the money is not wired to the closing agent prior to closing. Unlike the "should" items, there is no potential offset or deduction available for these amounts, and failure to wire the funds directly will result in a taxable event. To prevent any unwanted tax consequences, ensure these funds are wired without exception.

For these items you MUST wire the money from Seller to closing agent prior to close

Security Deposits:
Any tenant security deposits held by the seller must be transferred to the closing agent before the close. Failure to do so results in taxable boot.

Prepaid Rent:
If the tenant has paid rent in advance, the prorated portion attributable to the buyer must be transferred to the closing agent. The seller will already record the full rent payment as income on their tax return, so transferring the buyer's portion allows the seller to claim it as an expense and avoid boot.

Holdbacks / Deferred Maintenance:
Any amounts held back for deferred maintenance or other contingencies should be placed in escrow and not treated as part of the 1031 exchange. These funds should not be considered "exchange money" and should remain in escrow until the release terms are met. Receiving these funds later could potentially disqualify the exchange.

Fines and Other Penalties:
If the property is out of compliance with local regulations and incurs fines, these amounts should be settled prior to closing, as unpaid fines covered by the buyer will lead to boot and are not deductible.

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SHOULD ITEMS

These items can trigger taxable boot if not handled properly, but they may also have an offset on Schedule E (form 8825) of your tax return. If the seller fails to wire the money to the closing agent, an expense can often be claimed on the property's income statement, which could result in a net-zero tax effect. However, to ensure you receive the full tax benefit and avoid any risk of boot, it is recommended to wire the money to the title company at closing or pay outside of closing.

For these items you SHOULD wire the money from Seller to closing agent prior to close

Tax Prorations:
The seller must prorate property taxes collected from tenants or unpaid amounts for the period they owned the property. If the buyer's funds cover this, it results in boot. Ideally, the seller should wire these funds to the closing agent in advance. Alternatively, the seller may be able to claim the prorated amount as an expense on their property income statement, potentially offsetting the impact. Paying the cash at closing not only avoids boot but also allows the seller to claim the expense.

Interest on Loans:
Any interest due to the lender for the period between the last mortgage payment and closing should not be covered by the buyer's funds, as this creates boot. Again, the seller should wire the funds to the closing agent. As an alternative, the seller may record the interest as an expense, creating a net-zero effect. Paying this at closing ensures there is no boot and the seller can still claim the interest as an expense.

Tenant Improvements (TI):
If there is an unspent or unreimbursed tenant improvement allowance, these amounts will be treated as debt relief, increasing the debt the seller must replace in the exchange. It's crucial to factor this into the replacement property financing to avoid boot.

Utilities:
Prorated utilities paid by the buyer on behalf of the seller may also result in boot. Sellers should wire these amounts to the closing agent in advance or document them as expenses on the income statement to offset any potential taxable boot.

Items NOT considered boot and OK to have on closing statement

Broker Fees: Compensation paid to real estate agents or brokers for facilitating the transaction.

Financing Fees: (tied directly to the mortgage) Costs associated with securing a mortgage for the property, such as origination or application fees.

1031 Exchange Fees: Charges related to the administration and facilitation of the 1031 exchange, including qualified intermediary fees.

Title Insurance Policy: Costs for insuring the buyer's clear ownership of the property.

Mortgage Recording Fee: The fee paid to officially record the mortgage with the county or relevant authority.

Attorney's Fees: (related to transaction or mortgage) Legal fees incurred for services directly connected to the sale, purchase, or financing of the property.

Escrow and Settlement Agent Fees: Fees paid to escrow or settlement agents for handling the transaction are permissible expenses that won't trigger boot.

Transfer Taxes: Documentary transfer taxes required for the transfer of property ownership are considered allowable exchange expenses.

Environmental Inspections: If environmental inspections are needed for the property, their costs can be included without causing boot.

Survey Costs: Charges for land surveys required for the transaction are also permissible and won't create taxable boot.

Appraisal Fees: (if contractually required) Appraisal fees required under the purchase contract (not for lender purposes) are generally considered allowable.

Tax Advisor Fees: Any tax advisor fees specifically related to the transaction are considered allowable.

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