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Closing costs in a 1031 Exchange: Investors need to discuss all expenses with their tax advisors

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

The first has to do with whether payment of certain expenses will result in the exchange being partially taxable. There are categories of expenses called "exchange expenses" that can be paid with exchange funds without causing the transaction to become partially taxable.

The second issue is whether paying the expense will cause the taxpayer to have constructive receipt of exchange funds. If this happens, it is as if the taxpayer is controlling or actually holding the exchange funds, and the exchange may fail completely.

As with many 1031 exchange issues, there is very little guidance on this topic. This article explains generally the uncertainties and technical nature of these issues. It is essential that taxpayers have their tax advisor approve each closing statement and the manner of paying all costs.

Exchange Expenses: Certain expenses paid at a closing are considered "exchange expenses." Using exchange funds to pay those expenses won't result in tax liability to an investor doing a 1031 exchange. For example, Revenue Ruling 72-456 provides that using exchange funds to pay broker's commissions will not result in the transaction being partially taxable. There are few clear rulings, 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: Broker's commissions; exchange fees; title insurance fees for the owner's policy of title insurance; escrow fees; transfer taxes; recording fees; and attorney's fees in connection with the sale or purchase of the property.

Non-Exchange Expenses: Other expenses are not exchange expenses, so although exchange funds might be used to pay them, the exchange will be partially taxable. For example, security deposits and prorated rents are not considered exchange expenses. If exchange funds are used to pay them, the exchange will be partially taxable. This arises when the seller of relinquished property gives the buyer a credit at the closing for the security deposits and prorated rents. The result is as if the seller was using exchange funds to pay the security deposits and prorated rents. To avoid the tax, the seller should deposit his own funds to pay security deposits and prorated rents to the buyer. 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 purchase, and therefore under tax law are not exchange expenses. To avoid tax liability for these expenses, the buyer may want to deposit his own funds for such expenses.

Some non-exchange expenses create a tax liability, but are offset by a deduction taken by the investor.

The following expenses 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;

security deposits; prorated rents; insurance premiums; and 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, potentially ruining the entire exchange. The regulation states 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)." Thus, 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.

This issue can arise with respect to rate lock-in fees paid to a lender 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. Investors need to discuss all expenses with their tax advisors.

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