



## Treatment of transaction expenses for IRC Section 1031 tax deferred exchanges

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In order to have a fully tax deferred exchange most taxpayers are told that they must purchase a replacement property of equal or greater value to the relinquished property they sold. Technically this is incorrect as it is possible to purchase a property for slightly less than the relinquished property when taking into account transaction expenses.

The rules for obtaining a fully tax deferred exchange are:

1. Purchase a replacement property of equal or greater value than the relinquished property, less the total amount of deductible transaction costs;
2. Contribute the net cash received from the sale of the relinquished property toward the purchase of the replacement property;
3. Obtain equal or greater financing on the replacement property compared to the amount of debt satisfied at the closing of the relinquished property;
4. Purchase only like-kind property.

The ability to deduct transaction cost on both the sale and acquisition properties allows the taxpayer to use only the net funds obtained from the sale and not have to replace the transaction costs spent as well. The confusion occurs because not every transaction cost is considered to be directly related to the sale or purchase of the exchange properties.

Although there is little authority on the subject there are some general guidelines. Some examples of costs that are routinely paid from exchange funds are: real estate commissions, title insurance and escrow costs (fee policy only), attorney fees, recording fees, qualified intermediary fees, and transfer taxes.

Examples of expenses to the transaction that should not be paid for with exchange funds are fees related to financing the replacement property, such as application fees, points, mortgage recording fees, mortgage taxes, and title insurance for the mortgagee. In addition, property taxes and costs such as pre-paid rent and security deposits are not generally considered expenses. Pre-paid rent and security deposits should not be offset by lowering the purchase price as this may result on boot to the taxpayer. Instead they should be paid outside of the closing in a separate transaction.

There is also a group of expenses that, depending upon their treatment in the sale contract, might be able to be included in the closing expenses that can be paid for with exchange funds. These costs include the survey, environmental inspection, and engineering inspection. In many cases these transaction costs are incurred because they are a requirement of obtaining the title insurance policy or financing for the property, and as such, would not be directly related to the purchase of the property.

However, an argument could be made that these items are transaction costs that a taxpayer may choose to incur absent the requirements of a title company or lender. In order to make this

argument stronger it may be wise to put terms into the purchase contract making the purchase contingent upon the successful review of these items. Accordingly, these items become contingencies that must be reviewed in order to complete the transaction and the argument for their inclusion in the list of allowed expenses is stronger.

Care must be taken to distinguish transaction fees that may be paid for with 1031 funds from those that may not. It is always useful to ask whether a cost would be incurred absent the requirements of a third party to the transaction, such as a lender or title company. Lastly, it is always advisable to consult your tax and legal advisors before making these decisions.

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