1031 Exchange

Closing Costs, Credits, and 1031 Exchanges

Internal Revenue Code Section 1031 allows deferment of capital gains taxes on real property used in trade or business or held for investment

One of the most frequently asked questions from clients planning a 1031 exchange is: "Can I use my exchange funds to pay closing costs without creating a taxable event?"

Although the Internal Revenue Code provides surprisingly little specific guidance on this issue, several general principles can help taxpayers and their advisors structure a 1031 exchange while minimizing unnecessary capital gains taxes.

For purposes of this discussion, closing costs include expenses directly related to completing the sale or purchase of real property and that are typically reflected on the transaction's closing statement. Costs incurred outside the normal closing process generally should not be paid with exchange proceeds unless the exchanger is willing to recognize taxable boot.

Examples of these pre-closing expenses include repairs, maintenance, and other costs incurred to prepare a property for sale. Likewise, an exchanger generally should not be reimbursed for these expenses through escrow, as doing so may create taxable boot. In most cases, these expenses should be paid out of pocket.

Non-recurring costs directly related to the closing of the transaction can generally be paid using exchange proceeds. For sellers, these expenses typically reduce the net sales proceeds. For buyers, they generally increase the acquisition cost of the replacement property.

Examples include:
- Real estate commissions
- Escrow and title fees
- Recording fees
- Transfer taxes
- Qualified intermediary (1031 exchange) fees

Any recurring expenses, or costs that are not directly related to completing the closing, generally should not be paid using exchange proceeds without potentially creating taxable boot.

When selling property, these expenses should generally be paid out of pocket. When purchasing replacement property, they should typically be paid with loan proceeds, when available, or out of pocket.

Examples include:
- Mortgage interest
- Mortgage prepayment penalties
- Prorated property taxes
- Prorated utility charges
- Homeowners association (HOA) dues
- Insurance premiums

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