1031 Exchange FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS

> Closing Costs, Credits and 1031 Exchanges

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.

One of the most frequently asked questions from clients planning a 1031 Exchange is, "Can I use my exchange funds to pay for closing costs without being taxed"? Although surprisingly little guidance is available in the tax code, there are some rules of thumb that will help clients and their tax advisors determine how best to structure a 1031 Exchange without paying unnecessary capital gains taxes.

Closing costs, for purposes of this article, are defined as all costs associated with the closing of a property that is required to complete the transaction. Such costs are required to be disclosed to all sellers and buyers of real property in the HUD-1 Closing Statement. Any cost that is incurred outside of escrow or the closing process generally should not be paid for using 1031 Exchange funds, unless the exchange client is willing to pay tax on the amount spent. Such pre-closing items include all maintenance and fixer costs that are incurred to prepare the property for sale. In addition, exchange clients should not be reimbursed for such costs in escrow without being taxed. It is best to pay for such pre-closing costs "out of pocket".

Non-recurring costs specifically related to the closing can generally be paid for using exchange proceeds and will reduce the property's net sales price for sellers or increase the net purchase price for buyers. A non-inclusive list of such costs includes:

- Sales commissions
- Title and escrow fees
- Recording fees
- Transfer Taxes
- 1031 Exchange Intermediary fees

Recurring costs or costs that do not specifically relate to the closing should not be paid for using exchange proceeds without incurring a tax liability. When selling property, such costs should be paid for "out of pocket". When buying property, such costs should either be paid for with loan proceeds, if possible, or "out of pocket". These costs also do not decrease the net sales price or increase the net purchase price. A non-inclusive list of such costs includes:

- Mortgage interest
- Mortgage prepayment penalties
- All prorated expenses including property taxes, utilities, homeowner's fees and insurance expenses.

The subject matter in this newsletter is intended as general information only and not intended as tax or legal advice. Please always consult your tax or legal advisor for any specific tax or legal matters.

Phone: (877) 471-1031
Fax: (877) 480-1031
info@ax1031.com
www.ax1031.com

Asset Exchange Company