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1031 Expense Deduction Pitfalls Litter Exchange Deal Landscape

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Parties who buy or sell real estate usually adjust the payments made at closing to include all related transaction expenses. Adjustments at closing to reflect buyer and seller expenses is a widely accepted means of transferring funds at closing. However, some transaction expenses, if paid through adjustments at closing, may trigger adverse tax consequences to a taxpayer engaged in a "like-kind" exchange of real estate under Section 1031 of the Internal Revenue Code.

Under Section 1031, a taxpayer may defer recognized gains indefinitely without penalty or interest when selling property held for trade, business or investment purposes, provided that any gain from the sale of such property is applied towards the purchase of another "like-kind" investment property.

To minimize the recognition of gain in a 1031 Exchange, the taxpayer should deduct only those expenses that are directly related to the exchange. If the amount of net sales proceeds in a 1031 Exchange is adjusted to include indirect expenses, then such expenses may be considered taxable "boot" and, as such, may be part of recognized gain.

Although this article focuses on real estate transactions, the same theories hold true for like-kind exchanges of other property.

Broadly Worded

IRS Revenue Rulings and Tax Court memos offer the taxpayer limited guidance for determining what types of transaction expenses would reduce recognized gain in a 1031 Exchange. For example, in Revenue Ruling 72-456, brokerage commissions paid by a taxpayer were deemed a valid exchange expense, which reduced the recognized gain and increased the basis in the replacement property. In Blatt vs. Commissioner, the Tax Court suggested that a variety of exchange expenses could be deducted by the taxpayer to reduce the recognized gain in the relinquished property and increase the basis in the replacement property. Nevertheless, Blatt offers no guidelines to help the taxpayer determine what constitutes a valid exchange expense.

For guidance, we can look to Sections 1001 and 1012 to determine what exchange-related expenses are deductible in a like-kind exchange. In a typical real estate transaction, the gain recognized by the seller is the excess of the amount realized over the adjusted basis in the property. Section 1001 defines the "amount realized" as the sum of any cash received plus the fair market value of any property received. Generally, the "basis" of real property, as defined under Section 1012, may reasonably include a broad range of expenses that are directly related to the transaction. Such costs may include, among others: title exam and insurance, survey, legal fees, title insurance, recording fees, transfer tax and brokerage commission.

Rental deposits and pro-rata rent payments, on the other hand, are illustrative of expenses not directly related to the purchase of the property. Therefore, such expenses may not reduce the recognized gain in a like-kind exchange and, if deducted at closing, may be subject to capital gains tax.

> **By including indirect transaction expenses as either a credit or offset to the net proceeds of sale, the taxpayer may inadvertently create recognized gain.**

Upon the purchase of a replacement property, the taxpayer must again be cognizant as to which transaction expenses are directly related to the exchange and, as such, may be a permissible offset against the buyer's required purchase money proceeds. Certain direct transactional expenses, such as recording fees or brokerage commissions, validly increase the basis in the replacement property. On the other hand, adjustments for rents and deposits held by the seller are indirect expenses that may not increase the buyer's basis in the replacement property.

What is the consequence of applying indirect expenses to the amount of the buyer's payment at closing? One consequence is that the taxpayer may mistakenly calculate the value of the replacement property as the amount of cash proceeds needed at closing, which may include adjustments for indirect costs such as pre-paid rent and security deposits. This amount, to the extent it is less than the value of the relinquished property, may inadvertently create a recognized gain for the taxpayer.

The parties to a 1031 Exchange should not automatically include all transaction expenses on the settlement statement to determine the amount of the buyer's payment or the amount of net proceeds due the seller at closing. By including indirect transaction expenses as either a credit or offset to the net proceeds of sale, the taxpayer may inadvertently create recognized gain. Sellers and buyers engaged in a 1031 Exchange should consult with a tax advisor before including any adjustments at closing for transaction expenses. ■