1031 Exchange: What are Valid 1031 Exchange Selling Expenses?

When selling or purchasing an investment property in a 1031 exchange process, certain selling expenses paid out of the sales or 1031 exchange proceeds will result in a taxable event for the exchanger. Routine selling expenses such as broker commissions or title closing fees will not create a tax liability. Operating expenses paid at closing from 1031 proceeds will create a tax liability for the exchanger.

The IRS, through various revenue rulings has provided guidelines for allowable and unallowable closing and settlement costs based on common geographical practices and standards.

Allowable closing expenses for IRS 1031 exchange purposes are:

- Real estate broker's commissions, finder or referral fees
- Owner's title insurance premiums
- Closing agent fees (title, escrow or attorney closing fees)
- Attorney or tax advisor fees related to the sale or the purchase of the property
- Recording and filing fees, documentary or transfer tax fees

Closing expenses which result in a taxable event are:

- Pro-rated rents
- Security deposits
- Utility payments
- Property taxes and insurance
- Associations dues
- Repairs and maintenance costs
- Insurance premiums
- Loan acquisition fees: points, appraisals, mortgage insurance, lenders title insurance, inspections and other loan processing fees and costs

To reduce the taxable consequences of these operating, financing and other closing fees, try to:

- Pay security deposits, pro-rated rents and any repair or maintenance costs outside of closing, or deposit these amounts in escrow with the closing agent.
- Treat accrued interest, prorated property tax payments or security deposits as non-recourse debt that the exchanger is relieved of on the sale of their old property, which could be offset against the debt assumed on the replacement property. Note: this would only work if mortgage debt is obtained on the replacement property purchase that exceeds the mortgage debt paid off on the sale of the relinquished property.
- Match any prepaid taxes or association dues credited to the investor against the unallowable closing expenses listed on the settlement statement.

Check with your tax advisor prior to the closing to review the closing settlement statements to determine if there is an opportunity to avoid a taxable transaction in your 1031 exchange. It's possible that an exchanger has a long term loss carry forward or non-recognized passive operating losses that could offset the taxable amount.

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