Investments:

1031 Exchanges: The IRS Gives You Credit for Expenses

We all know that expenses are deductions from income tax. For example; if I buy a "widget" (a term used in business hypothetical scenarios when the details of the product aren't relevant to the example) for $500,000 and sell it for $1,000,000, I won't owe the IRS taxes on that $1 million: just on $500,000. ($1,000,000 gross proceeds - $500,000 cost = $500,000 taxable profit.)

This month, I realized that many investors don't know that similar "expense" deductions can apply to their 1031 exchange. For example: a client of mine was under the impression that, because he sold a property for $1 million, he needed to buy a $1 million replacement property. This was a problem because he only received $925,000 "net" after selling expenses. (Real estate commission, closing costs, etc.) After repaying his $500,000 loan, he was left with $425,000 in his accommodator's account.

My investor thought that he still needed to buy $1 million of replacement property and needed to assume a larger loan to cover the shortfall caused by those expenses. I told him about the deductions created by selling expenses, and he asked me to provide documentation of this. To my surprise, this documentation was tough to find: IRS publications would require reading and digesting thousands of words, and most of the accommodator websites that I checked seemed to ignore these deductions. I don't think the accommodators omitted this fact out of ignorance. Rather, in an attempt to simplify their examples, they simply created hypotheticals that assumed "no transaction costs." (I realized then than I do the same thing in many of my articles.

This inspired my article for this month. We will explore what is deductible, what is not even related to the exchange, and what expenses aren't even taxable in a 1031 exchange.

Expenses That Are Deductible

Any expenses that are directly related to the sales transaction are deductible. This includes items like real estate broker commission costs, accommodator fees, escrow and title insurance fees and filing fees.[1] Transfer taxes (if applicable in the property's location) are also deductible. [2]

Note that, although you may have completed the work in order to achieve a better sales price; or even during escrow as part of the sales process, maintenance work such as painting would not be deductible from your exchange. Note that this work is deductible – but from your operating income. Uncle Sam doesn't want you to write that off as part of your exchange – he wants you to write it off from your income. I'll expand on this in this article's next section.

Other Expenses that Are Deductible – But Not From Your Exchange

Similar to the example above, there are some expenses that are deductible – just not from your exchange. This includes credits to the seller such as prorated property taxes, prorated rents and security deposits.[3] Property taxes are an ordinary expense that is deducted from your income for tax purposes. Similarly, the prorated property taxes that you paid up to the day you sold the property are just ordinary expenses. Prorated rents and return of security deposits are a deduction from income in the form of income you received that really wasn't yours. That tax obligation is passed on to the new owner and removed from

Continued from page 31

your income as a deduction.

Some Sales Proceeds Are Not Taxable

The good news is that some of your sales proceeds may not be taxable because you have already paid taxes on them. Such proceeds include things like reserves funded from rents that are held by the lender or by your property/asset manager.

Many lenders may require that you fund a reserve account from your income every month, and may require you to make a monthly or annual payment in addition to your mortgage payment that funds this account – which they hold for you. This works the same way as property tax and insurance impounds do in residential loans. (Except that in commercial loans, they wouldn't be optional.) A commercial lender may want to hold these reserves for a future roof replacement or similar project that will maintain the value of their collateral. Similarly, many property or asset managers will ask their clients to contribute the property's income to a reserve account they control. These funds are usually kept on hand to address emergency repairs or minor repairs that can be done without waiting for your approval.

Both outlays cited above aren't taxable today because they were taxable in the past as income. In much the same way that your principal payments on a loan aren't a tax deduction (since you are using the money to pay down a debt,) contributions to reserves aren't deductions in the year they are made. They are, instead, taxed as a form of "phantom income" – a term used to describe income that you paid tax on, but didn't get (yet) to put into your pocket.

I hope that this month's article enhanced your understanding of which cash flows are included in, and which are excluded from, your 1031 exchange. This article is necessarily a summary – both in the interest of fitting into this magazine, and in keeping my readers awake. If you have any questions about your exchange, please call my office toll-free at (877) 313-1868, and I'll be happy to help. I hope that you're enjoying your summer!

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