

Why Do We Prorate Expenses at Closing?

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As we begin a new year, it is becoming more apparent that real estate continues to grow not only as an asset class but also as a diversification of an investment portfolio. With every real estate transaction, there are several things that buyers and sellers alike need to keep in mind. Making the decision to buy or sell should be backed by an in-depth evaluation of each of the pros and cons of the transaction. The key to a true understanding of your investment is to first understand how income and expenses are going to be distributed. Let's take a closer look at Iowa property taxes and how they will be handled at the real estate closing.

Calculating real estate taxes when you sell property in Iowa can be a complicated process. When you are in the planning stages of selling your property, the best estimate is to figure paying one year's real estate taxes at the time of closing. This will give a close estimate of what the seller will be responsible for; however, depending on the month you close on the property, it could be a little more or a little less.

When it comes to proration in a sale transaction, the purpose is to fairly divide the property expenses, like property taxes, between the Seller and Buyer so that each party is paying only for those days on which they actually own the property.

The property tax year does not follow the standard January through December standard calendar year. The property tax year runs from July 1st of one calendar year to July 1st of the next year. For example, a tax year may be described as 2021-2022 tax year, meaning the time period of July 1st, 2021, to June 30th, 2022.

The tax year is divided into two installments...

The 1st installment period runs from July 1st to January 1st. The payment for this installment period is due on September 1st and is delinquent and subject to penalty after October 1st.

The 2nd installment period runs from January 1st to July 1st. The payment for this period is due on March 1st and is delinquent and subject to penalty after April 1st.

In Iowa, property taxes paid this year count toward the previous fiscal year.

On the day of closing, the buyer owns the property and is responsible for the tax bills that come due on or after that date. Noting Iowa's taxes are always paid a year behind, the buyer is given credit to cover the property taxes during the year they did not own the property. The seller gives credit to the buyer for the time the seller owned the property, and the taxes were accruing but not yet payable.

Although taxes are the most common place to find prorations, when dealing with income producing assets, such as farmland, it is also important to have an understanding when income will be received and how that will be prorated in conjunction with when a buyer takes possession. In a number of situations, rent payments are made once a year but perhaps twice a year. Depending on the time of year your closing takes place, a proration of income may need to be negotiated for the portion of the year the current owner has had possession or when a new owner takes possession of the property. This proration of income should be negotiated as part of the transaction and dually noted on the purchase agreement if necessary. The same will hold true for government program payments such as CRP.

You may be asking yourself why it is important to understand when and why expenses and income are prorated. The answer is relatively simple: prorated costs can not only affect the short-term bottom line but also can be a very important part of the negotiation process when putting a real estate transaction together. At the end of the day, real estate is an income and profit-driven business. When you take into consideration each part of the purchase process, income, and other expenses, it could affect the bottom line. Real estate can offer more opportunities than any other asset class; however, understanding the closing process and all the parts and pieces it entails will only assist you with your real estate investment.