Investors Title Exchange Corporation
INNOVATIVE BY INSTINCT

Volume 1

# The Exchange


### What are the benefits of Exchanging v. Selling?

- A Section 1031 exchange is one of the few techniques available to postpone or potentially eliminate taxes due on the sale of qualifying properties.
- By deferring the tax, you have more money available to invest in another property. In effect, you receive an interest free loan from the federal government, in the amount you would have paid in taxes.
- Any gain from depreciation recapture is postponed.
- You can acquire and dispose of properties to reallocate your investment portfolio without paying tax on any gain.



## Taxable Boot in § 1031 Exchanges

By Carol Hayden, Esq.

An attorney recently lamented to me that some of his clients seem to think all they have to do is yell "1031!" and that magic number will make their capital gains taxes disappear. Taxpayers may be surprised to discover that even after effecting a 1031 exchange, they still owe some capital gains taxes.

It is widely understood that in order to completely defer gain, the taxpayer must trade up or equal in both fair market value and equity. Gain is, however, recognized in an exchange to the extent any "other property or money", referred to as "boot", is received by the taxpayer in the exchange. So, what constitutes boot?

Let's review the basic boot offset principles. Long and Foster, in their treatise *Tax-Free Exchanges under Section 1031* summarize these principles with the following four rules:

**Rule #1: "Liabilities incurred by the taxpayer in the exchange offset liability relief of the taxpayer in the exchange."** For instance, a loan paid off at the closing for the relinquished property is considered mortgage boot received, but can probably be offset by placing a mortgage on the replacement property.

**Rule #2: "Cash paid by the taxpayer in the exchange offsets liability relief of the taxpayer in the exchange."** That same mortgage boot received from the loan payoff in the sale of the relinquished property can be offset by cash paid by the taxpayer.

**Rule #3: "Cash received by the taxpayer is *not* offset by debt incurred by the taxpayer."**

**Rule #4: "Cash paid by the taxpayer *__in some circumstances__* offsets cash received by the taxpayer."** To understand this rule, one must differentiate between different types of cash boot. Cash boot received may be in the obvious form of cash, which will generally result in some tax liability. The receipt of cash boot may also result from the use of exchange funds for non-exchange expenses. The taxpayer may be able to offset the latter with cash boot paid.

Although the tax code does not specify what an *exchange expense* is versus a *nonexchange expense*, it is generally held that expenses necessary for the sale or acquisition of property and ordinarily found on closing statements are exchange expenses, and will not result in taxable boot. Exchange expenses may include: commissions, finder's fees, title insurance premiums, escrow fees, legal fees, intermediary fees, transfer taxes

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## Steps in the exchange process:

1. Fax ITEC a copy of the Exchange Order Form and contract(s) for the sale as soon as possible before closing.
2. ITEC will produce standard exchange documents and send them to your attorney for review.
3. The exchange documents must be signed at or before closing, and the net sales proceeds will be sent to ITEC. You will earn interest on the exchange funds as specified in the Exchange Agreement.
4. Identify your replacement property to ITEC within 45 days after closing the sale.
5. Contact us at least 5 days before the closing for the replacement property purchase so we can coordinate delivery of exchange documents and funds to the closing agent. The replacement property closing(s) must occur within 180 days of the first relinquished property closing. We will need a written authorization from you or your attorney in order to release funds to the closing agent.


**Be sure to arrange for ITEC to setup your exchange <u>PRIOR</u> to the closing of the relinquished property!**

**<u>Call ITEC at 1-800-724-8791</u>**

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# Taxable Boot in § 1031 Exchanges

**Exchange vs. Nonexchange Expenses**

| Exchange expenses may include: | Nonexchange expense include: |
|---|---|
| commissions | property taxes |
| finder's fees | utility charges |
| title insurance premiums | association fees |
| escrow fees | hazard insurance premiums |
| legal fees | security deposits |
| intermediary fees | prepaid rent |
| transfer taxes | loan costs (such as mortgage interest, loan fees, points, mortgage insurance, etc.) |
| recording fees | |

and recording fees. Other expenses that are not direct costs involved with the disposition of the relinquished property or acquisition of the replacement property are nonexchange expenses and may result in boot if paid with exchange funds. Nonexchange expenses include property taxes, utility charges, association fees, hazard insurance premiums, security deposits, prepaid rent, and loan costs such as mortgage interest, loan fees, points, mortgage insurance, etc.

Earnest money received for relinquished property may result in boot if it is retained by the taxpayer. He can offset the cash boot received by depositing the payment in escrow **prior** to closing of the relinquished property. If the taxpayer retains the deposit, it will be taxable to him at the time of the exchange.

Another way the taxpayer may receive cash boot is when the loan for the replacement property is too high. According to Rule #3 above, cash received by the taxpayer is not offset by debt incurred. The taxpayer should put all of the equity being held by the qualified intermediary into the purchase of the replacement property and then take out a loan only for whatever balance remains.

A Section 1031 exchange is an excellent mechanism for an owner of eligible property to trade into another qualifying property without the immediate recognition of a capital gain. It is important to realize that gain will be recognized to the extent that the client receives "other property or money". If a taxpayer wants to totally defer taxable gain, proper guidance concerning boot and boot offset principles is advisable.

Carol Hayden earned her undergraduate degree from Temple University and her J.D. from North Carolina Central University Law School. She has worked in the title insurance industry since 1993, managing like-kind exchange transactions as well as underwriting residential and commercial title insurance. She is Executive Vice President of Investors Title Exchange Corporation (ITEC). ITEC, founded in 1988, is a leading qualified intermediary in like-kind exchange transactions, facilitating as many as 300 exchanges per month involving properties throughout the United States.