Taxable Boot in Section 1031 Exchanges

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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. The utilization of 1031 exchanges by owners of investment or business property has increased dramatically since the final regulations of April 1991[1] went into effect. Even though these regulations have clarified several gray areas concerning tax-deferred exchanges and simplified the exchange process, there are still many reasons why the taxpayer needs competent counsel when anticipating an exchange. Taxpayers may be surprised to discover that even after effecting a 1031 exchange, they still owe an amount of capital gains taxes.

Complete Nonrecognition vs. Partial Nonrecognition of Gain
The exchange of qualifying like-kind properties under the regulations results in the nonrecognition of gain on the disposition of the relinquished property and a corresponding reduced basis in the replacement property acquired. It is widely understood that in order to accomplish complete nonrecognition of gain, the taxpayer must trade up or equal in both fair market value and equity.[2] Gain is, however, recognized in an exchange to the extent any "other property or money" ("boot") is received by the taxpayer in the exchange.[3] "Other property" received in an exchange would include either non-qualifying property or non-like kind property.[4] For instance, if a large parcel of undeveloped land is exchanged for a smaller parcel of farm land, a tractor, and some stock certificates, the gain on the disposition of the relinquished property would not be recognized to the extent of the farm land acquired, but would be recognized to the extent of the value of the tractor (non-like kind property) and the stock certificates (nonqualifying property).

Boot Receipt and Boot Offset
The question remaining, however, is what are other less obvious examples of "other property" to be aware of in a typical exchange, and how can receipt of such boot be offset to minimize taxable gain? A review of basic boot offset principles will help us understand what constitutes boot as well as the tax consequences of boot received in an exchange. Long and Vrbanac, in their treatise *Tax-Free Exchanges Under § 1031* summarize these principles with the following four rules:[5]

Rule #1: "Liabilities incurred by the taxpayer in the exchange offset liability relief of the taxpayer in the exchange."[6] For instance, a loan paid off at the closing for the relinquished property is considered mortgage boot received, but can probably be offset by mortgage liability incurred on the replacement property. The Tax Court, in *Fredericks v. Commissioner*[7], allowed the taxpayer to offset mortgage boot received from the relinquished property with mortgage boot given for the replacement property in a situation where the old loan was assumed by the purchaser of the relinquished property and the loan on the replacement property was from the seller. Both statutory and case law are vague, however, on the issue of new third-party financing on replacement property in

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an exchange. Although new third-party loans taken on replacement property are commonly seen in exchanges, the Tax Court, in *Wittig v. Commissioner*[8], attempted to disallow a taxpayer to offset mortgage boot received with mortgage boot given when the loan for the replacement property involved new third-party financing. However, after much complaint from tax practitioners, the court withdrew its decision.

Rule #2: "Cash paid by the taxpayer in the exchange offsets liability relief of the taxpayer in the exchange."[9] 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.[10]

Rule #3: Cash received by the taxpayer is *not* offset by debt incurred by the taxpayer.[11] In other words, "mortgage boot given does not offset cash boot received."[12]

Rule #4: "Cash paid by the taxpayer *in some circumstances* offsets cash received by the taxpayer." (emphasis added)[13] To understand this rule, one must differentiate between types of cash boot. Cash boot received in an exchange may be in the obvious form of cash, which will generally result in some tax liability. The receipt of cash boot may also result, however, from the use of exchange funds for non-exchange expenses. The taxpayer may in certain instances be able to offset the latter example of cash boot received with cash boot paid. This rule derives from Revenue Ruling 72-456[14] which found that the taxpayer was able to offset some of the cash he received at the end of the exchange by the payment of brokerage commissions on the sale of the relinquished property. Long and Vrbanac go on to say that, "In a deferred exchange, however, the Regulations take the position that cash received by the taxpayer during the exchange period may not be offset by cash subsequently paid by the taxpayer for the acquisition of the replacement property."[15] For that reason, cash paid by the taxpayer to offset cash boot received from the closing of the relinquished property should be paid at the closing of the relinquished property and not later. A look at exchange and non-exchange expenses typically found on closing statements will help further illustrate these concepts.

Transactional Items Found on Closing Statements

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,[16] and will not result in taxable boot.[17] Exchange expenses may include: commissions, finder's fees, title insurance premiums, escrow fees, legal fees, intermediary fees, transfer taxes, and recording fees.[18] 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.[19] Specific examples follow showing how taxable boot received in an exchange might be offset.

Nonexchange Expenses Related To Sale Of Relinquished Property

In a normal closing, prorated items such as a security deposit held by the seller or

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property taxes due from the seller, are typically paid to the buyer by debiting the seller's proceeds on the closing statement and showing a credit to the buyer. If this occurs in an exchange, the taxpayer would be considered to have liquidated a portion of his exchange equity. In a closing on the sale of relinquished property, these items would be considered non-exchange expenses and result in cash boot received by the taxpayer. As an alternative, the taxpayer could pay the security deposit or property taxes to the purchaser of the relinquished property outside of closing rather than allowing the buyer to receive a credit against the purchase price, thus avoiding the receipt of cash boot.

Nonexchange Expenses Related To Purchase Of Replacement Property

Common nonexchange expenses found on closing statements for the acquisition of replacement property may include fees for hazard insurance or association dues. Additionally, if the taxpayer's purchase of replacement property involves a loan, there are specific costs associated with acquiring the loan, such as points, origination fees, prepaid interest, and appraisals. Where exchange funds are used for these non-exchange expenses, the taxpayer will be considered to be in receipt of cash boot. In order to totally defer taxable gain, the taxpayer could utilize personal funds at closing for these nonexchange expenses. Another idea would be to simply pay from personal funds an amount (earnest money for example) sufficient to offset any cash boot received. If the taxpayer wants to minimize recognized gain, all of the exchange funds provided from the sale of the relinquished property should go towards *exchange expenses* and *equity*. Any remaining funds needed for loan closing costs or nonexchange expenses can be provided by cash the taxpayer brings to closing.

Receiving Earnest Money From Purchaser Of Relinquished Property

Often, the taxpayer will know when he enters into the relinquished property sales contract that he wants to exchange rather than sell the property. The earnest money will generally be held in an attorney's trust account or realtor's escrow account until closing, at which time it will be applied towards the purchase price. The taxpayer in this case will not be in constructive receipt of the earnest money. But what can be done if the taxpayer receives the earnest money deposit and cashes the check? Long and Vrbanac suggest that, "...[t]he taxpayer may arguably offset the cash boot received by cash boot given if the taxpayer deposits the payment in escrow prior to closing of the relinquished property. If the taxpayer retains the earnest money, it will constitute taxable boot at the time of the exchange."[20]

Receipt of Cash Boot at Replacement Property Closing

This situation occurs when the loan for the replacement property is too high. For example, suppose a relinquished property is sold for $100,000.00, and the exchange funds sent to the qualified intermediary. The taxpayer subsequently acquires replacement property for $150,000.00, but takes out a loan for $80,000.00. At the closing, the intermediary provides the $100,000.00 in exchange funds, but only 70,000.00 is applied to equity and the remaining $30,000.00 is refunded to the taxpayer. According to Rule #3 above, mortgage boot given does not offset cash boot received.[21] Sometimes the taxpayer may decide to take a higher loan knowing he will be taxed on the gain up to the amount of cash received. But if the taxpayer wants to totally defer taxable gain, he should lower

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the loan amount in order to avoid taking cash boot.

Conclusion

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.

[1]Treas. Reg. § 1.1031(k)-1.

[2]See JEREMIAH M. LONG & MARY FOSTER VRBANAC, TAX-FREE EXCHANGES UNDER § 1031 § 4:02. (West Group 1997).

[3]Treas. Reg. § 1.1031 (b)-1.

[4] Treas. Reg. § 1.1031(a).

[5]LONG & VRBANAC, *Supra.* note 2, § 4:06. (I am taking the liberty herein of changing the number order of Long & Vrbanac rules. Since their third rule is the most complex, I will reserve it for discussion last, as number four.)

[6]LONG & VRBANAC, *supra.* note 2, § 4:06; Treas. Reg. §§ 1.1031(b)-1(c), 1.1031(d)-2, Example (2); Rev. Rul. 79-44, 1979-1 CB 265.

[7] Fredericks v. Commissioner, TC Memo 1994027, 67 TCM 2005.

[8]Wittig v. Commissioner, TC Memo 1995-461, withdrawn Nov. 9, 1995, Dkt. No. 95-10460.

[9]LONG & VRBANAC, *supra.* note 2, § 4:06; Treas. Reg. § 1.1031(d)-2.

[10]See Rev. Rul. 79-44, 1979-1 CB 265.

[11]LONG & VRBANAC, *supra* note 2, § 4:06; Treas. Reg. § 1.1031(d)-2, Example (2)(c); Rev. Rul. 79-44, 1979-1 CB 265; Coleman v. Commissioner 180 F2nd 758 (CA8 1950).

[12]LONG & VRBANAC, *Supra*. note 2, § 4:07.

[13]LONG & VRBANAC, *supra.* note 2, § 4:06.

[14]Rev. Rul. 72-456, 1972-2 CB 468

[15]LONG & VRBANAC, *supra*. note 2, § 4:06; Reg. Sec. 1.1031(k)-1(j)(3), Example 2.

[16]See IRS Form 8824

[17]Rev. Rul 72-456, 1972-2 CB 568.

[18]LONG & VRBANAC, *Supra.* note 2, § 4:08.

[19]*Id.*

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[20]LONG & VRBANAC, *supra.* note 2, § 4:06.

[21]See Behrens v. Commissioner, TC Memo 1985-195.

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