



The Rules of "Boot" in a Section 1031 Exchange

A Taxpayer Must Not Receive "Boot" from an exchange in order for a Section 1031 exchange to be completely tax-free. Any boot received is taxable (to the extent of gain realized on the exchange). This is okay when a seller desires some cash and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 Exchange to be tax free.

The term "boot" is not used in the Internal Revenue Code or the Regulations, but is commonly used in discussing the tax consequences of a Section 1031 tax-deferred exchange. Boot received is the money or the fair market value of "other property" received by the taxpayer in an exchange. Money includes all cash equivalents plus liabilities of the taxpayer assumed by the other party, or liabilities to which the property exchanged by the taxpayer is subject to. "Other property" is property that is non-like-kind, such as personal property received in an exchange of real property, property used for personal purposes, or "non-qualified property." "Other property" also includes such things as a promissory note received from a buyer (Seller Financing).

Boot can be in advertent and result from a variety of factors. It is important for a taxpayer to understand what can result in boot if taxable income is to be avoided. The most common sources of boot include the following:

Cash boot received during the exchange. This will usually be in the form of "net cash received" at the closing of either the relinquished property or the replacement property.

Debt reduction boot which occurs when a taxpayer's debt on replacement property is less than the debt which was on the relinquished property. Debt reduction boot can occur when a taxpayer is "trading down" in the exchange.

Sale proceeds being used to service costs at closing which are not closing expenses. If proceeds of sale are used to service non-transaction costs at closing, the result is the same as if the taxpayer received cash from the exchange, and then used the cash to pay these costs. Taxpayers are encouraged to bring cash to the closing of the sale of their relinquished property to pay for the following non-transaction costs:

- Rent prorations.
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- Tenant damage deposits transferred to the buyer.
- Property tax prorations? Maybe, see explanation below.
- Any other charges unrelated to the closing.

Property tax prorations on the relinquished property settlement statement can be considered as service of debt based on PLR 8328011. Under this rationale exchange cash used to service tax prorations should not result in taxable boot. However, taxpayers may want to bring cash to the relinquished property closing anyway in order to resolve this issue.

Excess borrowing to acquire replacement property. Borrowing more money than is necessary to close on replacement property will cause cash being held by an Intermediary to be excessive for the closing. Excess cash held by an Intermediary is distributed to the taxpayer, resulting in cash boot to the taxpayer. Taxpayers must use all cash being held by an Intermediary for replacement property. Additional financing must be no more than what is necessary, in addition to the cash, to close on the property.

Loan acquisition costs with respect to the replacement property which are serviced from exchange funds being brought to the closing. Loan acquisition costs include origination fees and other fees related to acquiring the loan. Taxpayers usually take the position that loan acquisition costs are being serviced from the proceeds of the loan. However, the IRS may take a position that these costs are being serviced from Exchange Funds. This position is usually the position of the financing institution also. There is no guidance in the form of Treasury Regulations on this issue at the present time which is helpful.

Non-like-kind property which is received from the exchange, in addition to like-kind property (real estate). Non-like-kind property could include the following:

- Seller financing, promissory note.
- Sprinkler equipment acquired with farm land.
- Ditch stock in a mutual irrigation ditch company acquired with farm land (possible issue).
- Big T Water acquired with farm land (possible issue).

Acquisition of ditch stock or Big T water is a possible issue with the IRS. Most taxpayers report their exchanges of farm land by taking the position that water on the farm land is indistinguishable from, and the same thing as real estate. The IRS has been known to have a different view.

Boot Offset Rules - Only the net boot received by a taxpayer is taxed. In determining the amount of net boot received by the taxpayer, certain offsets are allowed and others are not, as follows:

- Cash boot paid offsets cash boot received (but only at the same closing table).

Cash boot paid at the replacement property closing table does not offset cash boot received at the relinquished property closing table (Reg. §1.1031(k)-1(j)(3) Example 2). This rule probably also applies to inadvertent boot received at the relinquished property closing table because of prorations, etc. (see above).

- Debt incurred on the replacement property offsets debt-reduction boot received on the relinquished property.

- Cash boot paid offsets debt - reduction boot received.
- Debt boot paid never offsets cash boot received (net cash boot received is always taxable).
- Exchange expenses (transaction and closing costs) paid (relinquished property and replacement property closings) offset net cash boot received.

Rules of Thumb:

- Always trade "across" or up. Never trade down (the "even or up rule"). Trading down **always** results in boot received, either cash, debt reduction or both. The boot received can be mitigated by exchange expenses paid.
- Bring cash to the closing of the relinquished property to cover charges, which are not transaction costs (see above).
- Do not receive property which is not like-kind.
- Do not over-finance replacement property. Financing should be limited to the amount of money necessary to close on the replacement property in addition to exchange funds which will be brought to the replacement property closing.