

## SEVEN RULES SALES AGENTS SHOULD KNOW ABOUT IRC 1031 “BOOT”

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Real estate sales agents are often the first professionals involved in commercial real estate transactions. Often they are also the professionals with the closest personal relationships to buyers or sellers. This early, personal involvement gives them a unique opportunity to help their clients to structure deals providing maximum net benefits that can go far beyond a favorable sales price.

Tax-deferred exchanges made pursuant to IRC §1031 offer a broad area where sales agents can do a lot to help clients achieve advantageous outcomes. Therefore, understanding of §1031 exchange law should be part of the total package of expertise that sales agents offer.

One important subject in §1031 exchange law that is often misunderstood is “boot.” In general, “boot” refers to anything of value given in a transaction to balance out a trade that otherwise would be unequal. A carriage horse, for example, might be traded for an inferior draft horse, along with a bit and harness thrown in *to boot*. In a §1031 exchange, “boot” refers to anything of value that the taxpayer received other than like-kind property.

The following seven rules can come in handy for a sales agent when considering the impact that “boot” can have in such a deal.

- Rule 1: Boot is taxed as profits in the year it is received. IRC §1031 provides tax deferral only for the exchange of *like-kind* property. Boot is property that is *not* like-kind, so it gets taxed. However, boot does not *void* an exchange.

- Rule 2: Boot should be avoided – *usually*. After all, tax deferral is the purpose of a §1031 exchange. This rule has some exceptions. For example, a taxpayer may want to balance a capital loss from a different transaction.
- Rule 3: Boot is taxed as pure profit. Many investors are under the misimpression that they can take out their initial investment and only shelter the profits through a §1031 exchange. In fact, as long as a taxpayer has any profit left in a transaction, every penny of boot he receives is profit. If he owns a property with an adjusted tax basis of \$700,000 and *sells* it for \$1 million, 70% of the proceeds is returned capital (no tax) and 30% is profit (taxed). If, instead, he exchanged this property for a property worth \$900,000, keeping \$100,000 cash as boot, 100% of the boot would be taxed as profit.
- Rule 4: Boot can be *anything* of value that is not like-kind property. Boot can be cash or a reduction in debt, a mortgage, unpaid taxes, the unpaid balance on a maintenance contract, the obligation to return security deposits, kitchen equipment or inventory. Boot can even be real estate that wasn't identified within 45 days or received within 180 days of the start of the exchange.
- Rule 5: Apply three tests to make sure there is no boot: First, the replacement property must have a fair market value equal to or greater than the fair market value of the relinquished property. Second, all net proceeds from the sale of the relinquished property must be invested into acquisition of the replacement property. Third, there must be equal or greater mortgage debt on the replacement property. (Additional cash can be a substitute for debt, but debt is no substitute for cash.)
- Rule 6: Boot could be hiding on the closing statement. Many closing costs can be paid with exchange funds. These costs are called “exchange expenses.” When they are paid for with exchange proceeds, the amount of cash that has to be invested in the replacement property is reduced. Brokers' commissions, transfer

tax, title insurance, escrow fees; counsel fees, exchange fees and recording fees are examples of “exchange expenses.” Costs that an accountant would call a *capital expense* associated with the transaction are usually in this category. Mortgage expenses, such as points and document preparation fees, are iffy. Unlike capital expenses, they are amortized over the life of the mortgage, not the life of the property. Many tax professionals believe that if these expenses are paid with exchange funds, that payment is boot. The taxpayer in consultation with his tax advisors may decide to give himself the benefit of the doubt and treat the expense as an exchange expense, but the practice is not usually advisable.

Expenses and adjustments that are related to property *ownership*, and are not directly caused by sale or exchange of the property, are *not* exchange expenses. They can be paid from exchange proceeds. However, that payment will constitute boot. Therefore, usually it is best to avoid paying these expenses with exchange funds. Examples of this class of expense include rent, utility and tax adjustments, mortgage escrows, insurance payments and tenant security deposits.

- Rule 7: Items become boot as soon as they are received or controlled by the taxpayer or his agent. Attorneys, accountants and brokers are some of the people who cannot hold exchange funds without turning them into boot. Therefore, closing proceeds should be handled by a third-party such as a §1031 exchange agent, and not by anyone closely associated with the taxpayer. To be safe, the same rule should be applied to *deposits* as well as to sales proceeds. However, there are arguments that deposits do not become proceeds until the time of closing, so, if brokers or attorneys find that they are holding deposits, they should transfer the money into a §1031 exchange account before closing, but the problem should be avoided when possible.

Of course, sales agents should never offer legal advice. Rather they should use these rules to identify §1031 opportunities and pitfalls early on in the transaction process,

adding value to their role as advisor. Clients can then discuss these issues with their own tax professionals, in order to obtain the best advice on avoiding boot and maximizing the benefit of their §1031 exchange.

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