Boot: Not Necessarily an Investor’s Booty

Boot isn’t always a treasure, especially in a 1031 exchange transaction. A 1031 exchange, sometimes known as a like-kind exchange, is a powerful tax code provision that allows a swap of one business or investment asset for another. One of the most common topics that cause confusion in a 1031 exchange is the concept of “boot.”

What is boot?

It is possible that in a 1031 exchange transaction, the relinquished property (the property being sold) and the replacement property (the property being bought) are of different value. Boot in a 1031 exchange is money or other property that is received or deemed received in an exchange but is not “like-kind” to other properties involved in the transaction. The goal is to avoid boot in order to successfully execute a tax-free transaction. If a seller does choose to receive boot, they should be prepared to pay taxes on the value of the boot.

Some common situations in which boot may arise in a 1031 exchange transaction include:

1. **Keeping some cash from the transaction.** Cash received at the closing of the relinquished property that is not reinvested into the exchange will be considered boot. For example, an investor sells the relinquished property for $1,000,000 but keeps $100,000 out of the transaction for personal use. That is, in its simplest form, cash boot.

2. **Sale proceeds used to pay non-closing expenses at closing.** If sales proceeds are used to pay costs at closing that are not closing expenses, the result may be the same as if the investor received cash proceeds and used the cash to pay these costs. However, transaction and closing costs paid with cash offset net cash boot received. It is also important to note that loan acquisition costs, such as origination and other fees related to acquiring the loan, may be considered boot and therefore may be taxable if the IRS determines these are being paid for by the exchange funds. This is determined by the IRS on a case-by-case basis.

3. **Debt reduction.** Debt reduction boot, also known as mortgage boot, occurs when the debt encumbering the replacement property is less than the debt encumbering the relinquished property. Debt reduction boot can occur when an investor is buying a replacement property that is lower in price or if an investor has less equity in the property. If an investor sells a property for $1,000,000 which has an $800,000 mortgage on it and purchases a replacement $1,000,000 property with only $600,000 in mortgage debt, the boot is the $200,000 difference in debt. Another debt reduction scenario may be an investor sells a property for $1,000,000 which has a $500,000 mortgage on it. The investor then buys a replacement property for $1,000,000, but finances only $300,000 on the replacement property. The investor does this by adding $200,000 in cash to the transaction. The investor received mortgage boot of $200,000 and gave cash boot of $200,000. So, is that a wash? The rules of offsetting boot outlined below should help explain the answer.
**Rules of Offsetting Boot**

- Cash boot paid offsets cash boot received at the same closing table. As an example, Bob puts down a $100,000 deposit for a replacement property from his own funds. At closing, the proceeds from his relinquished property are used to acquire the replacement property and, as a result, he gets back $100,000 at closing. That is cash boot, but the boot received is offset by the boot paid, therefore these net out.

- Cash boot paid offsets mortgage boot received. Bob sells his property for $1,000,000 which had $500,000 in mortgage owed. He buys a replacement property for $1,000,000, but pays all cash for this property. He received $500,000 in mortgage boot and paid $500,000 in cash boot, so these can be netted.

- Mortgage boot paid offsets mortgage boot received. Bob sells his property for $1,000,000 which had $500,000 in mortgage owed. He buys a replacement property for $1,000,000, but finances only $300,000 with a new loan. However, he assumes the seller’s loan of $200,000 remaining on the property. In this case, he paid $200,000 in mortgage boot by assuming the loan and received $200,000 in mortgage boot by reducing the balance on his mortgage, so these net each other.

- BUT mortgage boot paid does not offset cash boot received. Bob sells his property for $1,000,000 which had $500,000 in mortgage owed. He buys a replacement property for $1,000,000, finances $700,000 in a new loan and receives $200,000 back at closing. Bob paid $200,000 in mortgage boot because his loan increased and received $200,000 in cash boot because he got cash back at closing, but these cannot be offset against each other and he will be liable for tax on the $200,000 cash boot.

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**EXCHANGE EQUAL OR GREATER**

![Image showing exchange equal or greater]

<table>
<thead>
<tr>
<th>Relinquished Property</th>
<th>Cash Boot</th>
<th>Mortgage Boot</th>
<th>Replacement Property</th>
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In general, an investor that wants to avoid paying taxes in a 1031 exchange transaction should look to purchase a “like-kind” replacement property with a value equal to or greater than the value of the relinquished property. Investors should also plan to reinvest all of their exchange funds and make sure the debt on the replacement property is equal to or greater than the debt on the relinquished property.

The rules regarding boot are complex and may vary with the facts and circumstances particular to each investor in an Inland Private Capital Corporation-sponsored 1031 exchange program. This communication does not constitute tax advice for any particular investor. Potential investors must consult with their own tax advisors.

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**Important Risk Factors to Consider**

- No public market currently exists, and one may never exist, for the interests of any Inland Private Capital Corporation (IPCC)-sponsored program. The purchase of interests in any IPCC-sponsored program is suitable only for persons who have no need for liquidity in their investment and who can afford to lose their entire investment.
- IPCC-sponsored programs offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer. There is no guarantee that the investment objectives of any particular IPCC-sponsored program will be achieved.
- The actual amount and timing of distributions paid by IPCC-sponsored programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in local and state regulations applicable to owners of real estate and changing market demographics.
- IPCC-sponsored programs depend on tenants for their revenue, and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- IPCC-sponsored programs may own single-tenant properties, which may be difficult to re-lease upon tenant defaults or early lease terminations.
- Continued disruptions in the financial markets and challenging economic conditions could adversely affect the ability of an IPCC-sponsored program to secure debt financing on attractive terms and its ability to service that indebtedness.
- The prior performance of other programs sponsored by IPCC should not be used to predict the results of future programs.
- The IPCC-sponsored programs do not have arm’s length agreements with their management entities.
- The IPCC-sponsored programs pay significant commissions and fees to affiliates of IPCC, which may affect the amount of income investors earn on their investment. Persons performing services for the managers of the IPCC-sponsored programs perform services for other IPCC-sponsored programs, and will face competing demands for their time and service. The acquisition of interests in an IPCC-sponsored program may not qualify under Section 1031 of the Internal Revenue Code of 1986, as amended (the “Code”) for tax-deferred exchange treatment. Changes in tax laws may occur, and may adversely affect an investor’s ability to defer capital gains tax and may result in immediate penalties.
- The DST structure is inflexible and, in certain events, may be converted to a LLC structure, which would have a tax impact on investors.

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