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# Exchanges may be fully tax deferred or partially tax-deferred and partially taxable - by Robert Charland

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Exchanges may be fully tax-deferred or partially tax-deferred and partially taxable. An exchange will be partially taxable if the taxpayer receives net non-like kind property, (boot) in the exchange. Cash boot is received, and therefore taxable, when the taxpayer receives cash at the time of sale of the relinquished property. Taxable net cash boot may also be received if the taxpayer receives cash at the termination of the exchange in excess of the aggregate of the cash given by the taxpayer in the exchange. For example: the taxpayer uses personal funds to pay for the deposit on the replacement property contract in the amount of $10,000. At the termination of the exchange, following the receipt by the taxpayer of all like-kind property the taxpayer was entitled to receive, the qualified intermediary returns excess cash remaining in the exchange escrow in the amount of $11,000 to the taxpayer. The net taxable cash boot received by the taxpayer is $1,000, the difference between the cash boot received and the cash boot paid.

Net mortgage boot is received by the taxpayer if the mortgages paid off at the time of sale of he relinquished property are greater than the new mortgages taken on by the taxpayer in the acquisition of the replacement property. Notwithstanding, if the taxpayer is in receipt of net mortgage boot, the net mortgage boot received may not be taxable if it is offset by net cash boot given. For example: if the mortgages paid off at the time of sale of the relinquished property exceed the new mortgages taken on at the acquisition of the replacement property by $10,000 there is net mortgage boot received in the amount of $10,000. If the taxpayer has paid net cash boot in the amount of $10,0000 or greater, then the cash boot given offsets the mortgage boot received and there is no taxable boot. If the taxpayer has paid $7,000 of the mortgage boot received this would leave $3,000 net taxable boot received.

Simple rule of thumb for the boot offsetting provisions is as follows: If the taxpayer acquires replacement property of equal or greater value than the net sale price of the relinquished property and spends all of the relinquished property proceeds on the acquisition of the replacement property, then the exchange will be fully tax deferred. If the taxpayer follows this rule, then there is no cash boot received and the taxpayer either took on new mortgages in excess of the old mortgages (no mortgage boot received) or the taxpayer gave cash boot to offset any mortgage boot received.

There are some common misunderstandings about this rule. The rule has been interpreted to imply that if the taxpayer acquires replacement property equal to or greater in value than the net sale price of the relinquished property and the taxpayer takes on new mortgages in excess of the old mortgages then there is not net boot received. This interpretation is not always true however. For example; the taxpayer will be in receipt of net taxable cash boot if the taxpayer sells relinquished property valued at $100,000 with existing mortgages of $70,000 and acquires replacement property valued at $150,000 with $125,000 of new mortgages. In this example, the taxpayer cashed out $5,000 equity and is in receipt of net taxable cash boot. The taxpayer over financed the acquisition of the replacement property, which resulted in the receipt of net taxable cash boot in the amount of $5,000.

Other common misconceptions are that the taxpayer can receive net cash in an exchange in the amount of the taxpayer's initial capital investment in the acquisition of the relinquished property or that the taxpayer need only replace the profit in the relinquished property and not its value net of exchange expenses. Other taxpayers may think that they need only replace the equity in the relinquished property (equity equals value minus mortgages) to be fully tax deferred. In all of these cases, the taxpayer would be in receipt of taxable boot either as net cash boot or net mortgage boot received or both.

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