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The right time to take the boot - Understanding the risks of taking cash out of a Â§1031 exchange

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Timing the receipt of boot is critical in a Â§1031 tax deferred exchange. Taking boot at the beginning stages may blow the exchange or complicate how taxes are paid. If you want to leave a Â§1031 exchange clean, put all of the money in at the beginning and take the boot at the end.

Some exchangers take boot at the sale of a property by assigning a percentage of the sale contract to the qualified intermediary (QI) and pocketing the remaining funds. For example, Bob and Jane Smith sell their property for $100,000, but want to receive $10,000 of cash boot at closing and defer the remaining $90,000 in a Â§1031. So, they assign 90% of the property to the QI. Most conservative attorneys interpret the 1991 safe harbor regulations to state that the entire contract must be assigned to the QI, not a percentage.

The safe harbor regulations say that if a QI is used then "no alleged constructive receipt, agency or exchange failure defects can apply to the transaction." In other words: the exchange is protected. However, this protection applies only if all the QI safe harbor regulations are satisfied. Otherwise, the exchange is subject to the old laws, which are often muddled and uncertain. In the example given, it may be interpreted that not all of the safe harbor regulations are satisfied.

From the sale of a relinquished property, an exchanger has 45 days to identify the replacement property(s). The 200% identification rule gives the exchanger greater flexibility by allowing for the identification of more than three properties. The 200% rule allows an exchange to identify an unlimited number of replacement properties as long as the total value of properties identified doesn't exceed 2 times the value of the relinquished property. By taking the 10% boot at the beginning, the Smiths will lessen the value of property they can identify.

Another benefit of waiting until the end of the exchange period to receive boot is when the sale of the relinquished property occurs in the second half of the year. Cash boot received 180 days later occurs in the next calendar year. If the taxpayer's intent is to use all the proceeds to purchase a replacement property, but they end up reinvesting only a portion, then the tax code would defer recognition of the cash boot gain until the tax year is received. Thus, one year of deferral is achieved.

Boot is not always taxed at the 15% capital gain rate. If depreciation deductions have been taken prior to the sale of the relinquished property then those amounts are taxable at the 25% federal rate, unless fully deferred under Â§1031. In fact, if the total of depreciation claimed exceeds the cash boot received, the entire amount of boot will probably be taxed at 25%.

To obtain additional copies of this article or specific advice on this topic, please email Kevin directly at knulton@wes1031.com.

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