



Partial cashing out in a 1031 exchange – Will you still benefit? - by Pamela Michaels

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Investors in the Northeast generally have significant capital gain when they sell real estate held for investment. Many, in addition, have little or no mortgage debt on the property. Thus, the question arises: “May I put some cash in my pocket at closing and still perform a IRC 1031 exchange?” The answer is yes. The section 1031 code allows partial exchanges. Any cash pocketed at closing is considered “cash boot” and likely taxable but one must also determine whether if cash is pocketed, the exchanger will still benefit from the exchange.

What is a partial exchange?

In a partial exchange, the investor decides to defer some capital gain taxes and also pay taxes on either 1) cash proceeds received or 2) a reduction on their replacement property debt obligations — both of these events result in the receipt of “boot” which refers to any property received in an exchange that is not considered “like-kind.” [Cash boot refers to the receipt of cash. Mortgage boot is a term describing an investor’s reduction in mortgage liabilities on a replacement property. Any personal property received is also considered boot in a real property exchange transaction.]

When can cash proceeds be received?

Cash proceeds can be received as follows:

- 1) When the investor instructs the closing officer to dispurse a fixed dollar amount of proceeds to them directly from the relinquished property closing; or
- 2) After all identified property has been purchased or after the end of the exchange period if there are properties which have been identified but not purchased.

What are the requirements for full tax deferral in an exchange?

If an investor intends to perform an exchange that is fully tax deferred instead of partially deferred,

they must meet two specific requirements:

- 1) Reinvest the entire net equity (net proceeds) in one or more replacement properties; and
- 2) Acquire one or more replacement properties with the same or a greater amount of debt. [One exception to the second requirement is that an exchanger can offset a reduction in debt by adding cash to the replacement property closing.]

Will the investor still benefit if they perform a partial exchange?

This is where an analysis of the investors's tax situation by the investor's CPA is critical.

In order to determine if an investor will benefit from a partial exchange, it is necessary to compare the capital gain the investor would incur if no 1031 exchange is done with the boot resulting from a partial exchange. If the boot is equal or greater to the capital gain, there will likely be no benefit to the exchange as the investor will pay the same tax with and without the exchange. Investors are taxed on the boot resulting from a partial exchange up to the full amount of the investor's capital gain.

Example: Investor is selling a commercial property for \$5 million. There is no mortgage debt on the property. The investor's adjusted basis in the property is \$3 million. If the investor does not exchange, there will be a capital gain of \$2 million (less closing costs) which will be taxable unless the investor has other offsets. The investor elects to perform a partial exchange cashing out at closing on \$1 million and buying replacement property with all cash for \$4 million. The \$1 million is taxable as boot but the investor still benefits from the exchange as tax on \$1 million (the boot) is less than tax on \$2 million (the investor's total capital gain).

The bottom line: If the boot is greater than the amount of the capital gain, then it's not recommended to do a 1031 exchange.

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