Reinvestment Requirements to Achieve Complete Tax Deferral with a 1031 Exchange

The reinvestment goal of any 1031 tax deferred exchange should be to buy replacement property of **equal or greater value** and to use up all the exchange proceeds in the closing of the replacement property without getting any cash back. Receiving cash, sometimes called boot, will generally trigger a taxable event for the taxpayer, and should be avoided.

Sometimes, the taxpayer receives their replacement property settlement statement, and it shows that they are getting cash back. What possibly could have caused this? Below are a few examples of what may have caused the cash back scenario and what can be done to fix the settlement statement prior to the closing in order to avoid the cash boot:

- Other credits may appear on the settlement statement
- Taxpayer loan terms may need to be adjusted
- Taxpayer may be purchasing other properties

Credits on the Settlement Statement Contributing to Cash Boot

If the settlement statement has a credit for earnest money that the taxpayer paid out of pocket, the settlement agent can show an offsetting debit line item and title it “Reimbursement of prepaid earnest money to the buyer.” However, if the qualified intermediary was instructed to pay the earnest money out of the exchange proceeds prior to closing, this offsetting debit is not an option because the taxpayer can’t be reimbursed for an item that they did not prepay out of their pocket.

If the other credits include a credit for property taxes, rent, or security deposit prorations, the taxpayer should consider asking the seller to pay these items to the taxpayer outside of closing or to ask the closer to show these items as paid outside of closing and not as a credit line item. Even though these non-exchange items are customarily shown as a credit, it is best if they are handled outside of the closing.

Adjusting Loan Terms to Avoid Cash Boot

If a taxpayer is buying replacement property and is obtaining a loan as a part of the purchase, care must be taken to ensure that all of the exchange proceeds are reinvested into its acquisition. There have been lenders who have advised clients to combine exchange proceeds with a high balance loan, allowing the taxpayers to receive excess cash back in the closing process. In their opinion, the cash back is related to the loan proceeds rather than the exchange proceeds. Unfortunately, the Internal Revenue Service (IRS) does not interpret cash back through the closing that way. From the IRS’s perspective, the taxpayer is tapping equity through the exchange, and the equity (cash) received will be considered taxable boot if it is done through the closing. A better route would be to:

- Lower the loan amount or
- Consider a principle reduction on the settlement statement for the amount of the excess cash back

If the goal is to get some cash back without triggering taxation, one can refinance the relinquished property prior to starting an exchange or refinance the replacement property after the exchange is complete. Refinancing the relinquished property prior to selling is generally discouraged unless you can argue that the refinance was not in anticipation of the upcoming exchange or it was for independent business reasons. The preferred method is to refinance the replacement property after the exchange is complete.

Purchasing Additional Properties to Avoid Cash Boot

If cash remains after the measures above are taken, there is a chance the taxpayer has the intent to purchase more than one replacement property. If that is the case, the closer should only credit the buyer for proceeds needed to purchase the property, without sending cash back to the buyer. The remaining proceeds will be held by the qualified intermediary pending further purchase transactions.

If the taxpayer is struggling to find properties to consume their remaining exchange proceeds and still within the 45-day identification period, they should call their qualified intermediary or counsel to discuss alternative forms of investment. Many taxpayers do not realize that investing in certain energy royalty interests, water rights, or passive fractional interests (Delaware Statutory Trusts) may qualify as like-kind under the 1031 rules and allow them to further their tax deferred reinvestment goals.