

The Exchange Equation

Balancing the Exchange

1031

Knowledge

REALIZED GAIN vs. RECOGNIZED GAIN

Whenever property is sold, it is important to make the distinction between realized gain and recognized gain. Realized gain is defined as the net sale price minus the adjusted tax basis. Recognized gain is the taxable portion of the realized gain. The common objective in a 1031 exchange is disposing of a property containing significant realized gain and acquiring a like-kind replacement property so there is no or little recognized gain. In order to defer all capital gain taxes, a taxpayer must balance the exchange by (1) acquiring replacement property that is the same or of greater value than the relinquished property; (2) reinvest all net equity and; (3) replace debt on the relinquished property with debt on the replacement property, if any. (A reduction in debt can be offset with additional cash.)

THE EXCHANGE EQUATION

The taxpayer can quickly calculate whether there will be recognized gain based on the following principles: Taxable "boot" is defined as non like-kind property a taxpayer may receive as part of an exchange. "Cash boot" is the receipt of cash. "Mortgage boot" (also referred to as debt relief) is a reduction in a taxpayer's mortgage liabilities on a replacement property. Generally, capital gain is recognized (and therefore taxable to the extent there is a capital gain tax consequence) when there is boot.

For a fully deferred exchange, a taxpayer should reinvest all net equity and acquire property with the same or greater debt. Compare the relinquished property with the replacement property in terms of:

1. **Value**
2. **Debt**
3. **Net Equity** (after deducting costs of sale)

<u>EXAMPLE 1</u>	Relinquished Property	Replacement Property
VALUE	\$450,000	\$600,000
DEBT	\$250,000	\$400,000
NET EQUITY	\$200,000	\$200,000

The taxpayer is acquiring property of greater value, reinvesting the entire net equity and increasing the mortgage on the replacement property. **Analysis:** There is no boot and no recognized gain.

<u>EXAMPLE 2</u>	Relinquished Property	Replacement Property
VALUE	\$450,000	\$600,000
DEBT	\$250,000	\$450,000
NET EQUITY	\$200,000	\$150,000

The taxpayer keeps \$50,000 of the exchange proceeds, reinvesting only \$150,000 as a down payment on the replacement property. **Analysis:** There is \$50,000 of cash boot which results in recognized (taxable) gain.

<u>EXAMPLE 3</u>	Relinquished Property	Replacement Property
VALUE	\$450,000	\$350,000
DEBT	\$250,000	\$150,000
NET EQUITY	\$200,000	\$200,000

The taxpayer acquires property of a lower value and, while reinvesting all equity in the replacement property, acquires less debt in the process. **Analysis:** The taxpayer has reduced the debt by \$100,000 (mortgage boot) which results in a recognized (taxable) gain of \$100,000.

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