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Exchange Computations: How To Make and Survive Them.

By Richard A. Goodman

Introduction

Every Exchange requires the making of several calculations. Although these computations usually are made by a tax-payer's tax accountant, everyone considering an exchange should have a basic understanding of them in order to decide whether to exchange, what type of property to acquire and how to deal with loans both on the property being disposed of (the "Relinquished Property") and on the property being acquired (the "Replacement Property"). This article will explain these computations in simplified form.

Realized Gain

The first calculation in every exchange is the taxpayer's realized gain, which is the gain on which the taxpayer would be taxed if the Relinquished Property was sold rather than exchanged. The taxpayer's realized gain is computed by subtracting the taxpayer's "adjusted basis" from the "amount realized." This computation is best explained with an example:

Example:

Assume that X purchased an apartment building for \$110,000. Over the years, X has taken \$20,000 of depreciation deductions and has made one capital improvement (a new roof) at a cost of \$12,000. X sells

the apartment building for \$200,000 cash. In the sale, X's \$60,000 mortgage is paid off. X pays a brokerage commission of \$10,000 and other expenses of sale (i.e., inspection fees, title and escrow fees, transfer taxes, recording fees and legal fees) totaling \$15,000. X receives a credit of \$3,000 in escrow for property taxes. X's realized gain is computed as follows:

Sales Price	\$200,000
Less Expenses of Sale	\$25,000
Amount Realized	\$175,000
Cost Basis	\$110,000
Plus Capitalized Costs	\$12,000
Less Depreciation	\$20,000
Adjusted Basis	\$102,000
Realized Gain	\$73,000

Several things should be noted about the computation of realized gain:

- Before even considering a tax-deferred exchange, a taxpayer should know his or her approximate realized gain. If the tax-payer has little or no realized gain, an exchange may be totally inappropriate.
- Prorations and credits for income (e.g., rents and security deposits) and for expenses (e.g., property taxes and insurance) relating to the Relinquished Property are not included in determining realized gain.
- The mortgage against the Relinquished Property is irrelevant in computing realized gain.

Recognized Gain

If a taxpayer chooses to sell the Re-

linquished Property, all of the realized gain is recognized, or currently taxed as a result. If the taxpayer exchanges the Relinquished Property under IRC section 1031, the taxpayer's realized gain is recognized only to the extent of the net boot received by the taxpayer in the exchange.

There are two types of boot:

-- "Mortgage Boot" consists of liabilities assumed in the exchange. If the taxpayer's mortgage is assumed or paid off, the taxpayer "receives" mortgage boot. If the taxpayer assumes another party's mortgage in the exchange, the taxpayer "pays" mortgage boot.

-- "Cash Boot" consists of cash and non-like-kind property transferred in the exchange. Oddly enough, a promissory note executed by a party to an exchange is cash boot, not mortgage boot. A taxpayer who receives money or unlike kind property "receives" cash boot. A taxpayer who pays money or gives non-like kind property in the exchange "pays" cash boot. The following rules illustrate how the taxpayer's net boot is determined.

Rule 1:

If a taxpayer receives either cash boot or mortgage boot and does not pay any boot in the exchange, the taxpayer's realized gain is recognized to the extent of the boot received.

Rule 2:

If a taxpayer receives both cash boot and mortgage boot and does not pay any boot in the exchange, the taxpayer's realized gain is recognized to the extent of the sum of the cash boot and the mortgage boot received.

Example:

Assume that A's property has a fair market value of \$200,000 and is encumbered by a loan of \$50,000, which B assumes in the exchange, and that B's property has a value of \$120,000 and is unencumbered. A's equity in his property is \$150,000 and B's equity in his property is \$120,000. To balance the equities, B must pay A \$30,000. A, therefore, receives \$80,000 of boot (i.e., \$50,000 in mortgage boot and \$30,000 in cash boot). If A's realized gain is less than \$80,000, the entire realized gain is recognized in this exchange. If A's realized gain exceeds \$80,000, only \$80,000 of the gain is recognized.

Boot Offset Rules

Things get more complicated if the taxpayer both pays and receives boot in the exchange. Additional rules are needed to determine how the exchange is taxed:

Rule 3:

Mortgage boot received is offset by mortgage boot paid.

Example:

If the taxpayer assumes an \$80,000 mortgage on the Replacement Property and is relieved of a \$50,000 mortgage on the Relinquished Property, the \$50,000 debt relief constitutes mortgage boot received but it is offset by the \$80,000 of mortgage boot paid, so the taxpayer receives no net boot.

Rule 4:

Net mortgage boot received is offset by cash boot paid.

Example:

If a taxpayer is relieved of an \$80,000

mortgage on the Relinquished Property, but pays \$100,000 cash (or executes a note for \$100,000) in the exchange, the mortgage boot which the taxpayer receives (i.e., \$80,000) is offset by the cash boot which the taxpayer pays in the exchange (i.e., \$100,000), so the taxpayer receives no net boot.

Rule 5:

There is no clear rule as to whether cash boot received may be offset by cash boot paid. Rule 5 needs a little explanation. If the cash boot paid and the cash boot received are both cold hard cash, the taxpayer is entitled to offset one against the other. The uncertainty arises when the taxpayer executes a note as part of acquiring the Replacement Property (and thereby pays cash boot) and receives cash boot in the form of cold hard cash to balance the equities in the exchange. If the taxpayer can offset the cash boot received by the cash boot paid, the taxpayer can have his cake and eat it too: he can end up with a fully tax-deferred exchange and put money in his pocket at the same time! As I have said, however, it has not yet been resolved whether a taxpayer is entitled to make this offset. Given the uncertainties, any taxpayer considering such an exchange certainly should seek tax advice.

Rule 6:

Expenses of sale are offset against cash boot received. Although the law is not fully settled in this area, it is extremely likely that the IRS or the courts ultimately will hold that if a portion of the exchange proceeds is used to pay normal selling expenses, those expenses will be offset against cash boot which the taxpayer receives. These expenses should include inspection fees, escrow fees, transfer taxes, recording fees and legal fees. Fees paid to the exchange intermediary should receive the same treatment.

Basis

A complicated computation is required

to determine the taxpayer's basis in the Replacement Property. However, there is a shortcut rule of thumb for determining that basis:

Rule 7:

The taxpayer's basis in the Replacement Property is the purchase price of that property reduced by any gain not recognized in the exchange.

Conclusion

Given the importance and complexity of the tax computations in an exchange, every taxpayer should obtain competent tax advice with regard to every exchange. Taxpayers should not seek tax advice from real estate brokers, escrow officers or exchange intermediaries. As with everything, an ounce of prevention is worth a pound of cure!

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